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The Chairman
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30 October 2013

Dear Mr Stevenson

Ernst & Young's global submissions to the IASB on the Exposure Drafts ED/2013/7 – *Insurance*

Please find enclosed Ernst & Young's global submissions to the IASB on the above Exposure Draft.

Yours sincerely

Ernst & Young

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International Accounting Standards Board
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28 October 2013

Dear IASB members

Invitation to comment – Exposure Draft Insurance Contracts

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, welcomes the opportunity to offer its views on the revised Exposure Draft, *Insurance Contracts* (ED).

The revised ED contains several changes made in response to comments received on the 2010 proposal and many of these changes are consistent with our recommendations in response to the 2010 ED. Notwithstanding that the IASB responded to many of our previous concerns, and our support for the general direction of the revised ED, we continue to believe that additional changes are necessary to improve the proposal in the revised ED. We are concerned that the Board may not have struck the right balance, in some areas, between enhancing the usefulness of financial reporting versus the costs of applying the proposal. The increased complexity of the proposal in the revised ED could also lead to reduced transparency and reliability of the information provided to users. Additionally, some aspects of the proposal may be difficult for companies to implement and explain, or for users to comprehend.

A global insurance standard

We continue to believe in the importance of a single set of high-quality global accounting and financial reporting standards and we strongly support the convergence of IFRS and US GAAP. However, with regard to accounting guidance for insurance contracts, the IASB and FASB (collectively, the Boards) have not been able to fully converge their respective proposals. We encourage the Boards to continue to work together to minimise the differences in their respective insurance contracts standards, thereby making them more comparable. However, we are concerned that the time necessary to jointly re-deliberate and fully converge may result in a further delay of the issue of a final IFRS standard on insurance contracts. Such a delay would mean that there will continue to be inconsistency in how companies report insurance contracts under IFRS. Therefore, the insurance project should remain a priority for the IASB and we believe the IASB should, as soon as possible, issue a revised IFRS 4 standard, even if this were to mean that the IASB has to issue a new insurance contracts standard within a timeframe that differs from that of the FASB.

Whilst we believe the IASB should proceed to revise IFRS 4, we believe that the Boards should utilise the feedback received from respondents to their respective proposals to identify those areas where their proposed guidance differs. The Boards may be able to jointly re-deliberate and eliminate differences that require limited effort to be resolved. We acknowledge the foregoing approach is likely to result in some differences between the IASB's and FASB's respective standards.

We have responded to the specific questions raised in the ED to provide suggested improvements to the proposed accounting. Those responses are set out in Appendix A to this cover letter. We have also responded separately to the FASB with respect to their proposal (attached as Appendix B to this letter).

Preparers have a variety of concerns about the IASB's proposed standard. The nature of these concerns appears to be driven by geography, past practice based, in part, on local regulation, and differences in the insurance products offered. We also notice divergent views among users. As mentioned, we support the Board's goal to achieve a consistent global accounting model for insurance contracts. At the same time, the existing diversity creates challenges in completing the project on the basis of one particular measurement and presentation approach. Considering the widespread diversity that currently exists and the urgent need for a solution for the longer term, we would be willing to accept a standard that, while eliminating most of the diversity seen in today's practice, would allow for some differences between companies by permitting a limited choice for measurement and/or presentation. Such choices would give companies the ability to decide how best to reduce accounting mismatches for the different types of contracts they issue, and how they manage their business to fulfil their obligations.

Accounting mismatches

The development of a global standard for insurance contracts has had many challenges due to the complexity of some of the insurance products issued, differences in how companies run their businesses to enable them to fulfil their obligations under the insurance contracts they issue, and regulatory restrictions within the insurance industry. A key issue that was raised in the comment letters on the 2010 ED, and which continues to be raised in response to the revised proposal, is volatility in both profit or loss and equity, whether caused by accounting mismatches or for other reasons. We agree with the principle that, where an economic mismatch cannot exist, accounting mismatches should be avoided. At the same time, the model should reflect the impact of economic events on a company's results in a transparent way. We acknowledge that the Board deliberated at length (in response to concerns raised in the comment letters to the 2010 ED) how to distinguish between accounting and economic mismatches and proposed a solution, principally utilising Other Comprehensive Income (OCI), to align the presentation of impacts of changes in interest rates for assets and liabilities. However, we believe that the Board's recommendation only addresses one dimension of a company's assets. That is, the fixed income portion of assets that are invested until they are needed to pay obligations. Many of the longer-term products that insurers issue are complex and offer benefits directly or indirectly linked to long-term returns based on diverse investments (e.g., debt, equity, real estate and derivatives). Whilst we believe that the accounting for insurance liabilities should not depend on the types of assets that a particular insurer holds, we are concerned about inconsistent measurement and presentation of insurance liabilities and assets that back those liabilities, resulting in accounting mismatches. We describe possible ways to address our concerns below.

Optional use of OCI

The proposed model requires the effect of changes in interest rates on the measurement of the liability for most insurance contracts to be reported in OCI. This proposed accounting was changed from the 2010 ED to address the insurance industry's concern that profit or loss volatility occurs when all changes in the insurance portfolio are reported through profit or loss. The required use of OCI was linked to a proposed change to IFRS 9 *Classification and Measurement*, which requires the impact of changes in fair value of certain assets to be reported in OCI. Because the types of assets for which fair value changes are recognised in OCI are limited to those that satisfy the 'characteristics' criterion, the Board's decision to require interest rate changes for insurance contracts to be recognised in OCI is likely to create accounting mismatches. We believe that companies should be able to choose to eliminate such accounting mismatches by permitting them the option to report interest rate changes on selected portfolios of insurance contracts through profit or loss. Providing such an option would mean that full comparability between insurers would not be possible, but we believe that appropriate disclosure of how the interest rate changes impacting insurance liabilities are reported would provide users with sufficient information to understand and, if necessary, adjust for the lack of comparability.

Generally, we concur with the Board that offering accounting choices in a standard should be avoided where possible. However, where there is a clear underlying rationale, for example, avoiding accounting mismatches, this optionality would be an acceptable alternative and, in the light of the insurance project, would reduce barriers to completing the standard.

Insurance contracts that offer a link to investment results

We agree with the IASB's view that when the risks are borne by the policyholder, the accounting model should reflect who is retaining that risk (i.e., the policyholder). In situations where an economic mismatch cannot exist between the terms of the participating feature in an insurance contract and the underlying items, the Board proposes to achieve this objective by measuring (a portion of) the liability by reference to these underlying items. This exception to the building block model is combined with a consistent presentation of changes in that (portion of the) liability and the underlying items (the so called 'mirroring' approach). Using such a mirroring approach to align the measurement of the insurance liability to the assets held is one way to reflect (in the insurance model) the fact that the policyholder is retaining most of the risk.

The proposal to eliminate accounting mismatches that would otherwise arise from the application of the building block approach when the liability measurement model is not aligned with that of the underlying items, according to the applicable IFRSs, is based on a conceptually sound objective. However, the proposal introduces many challenges that may make the application of the proposal potentially less transparent because of the inherent complexity and the need for arbitrary determinations about the decomposition of the cash flows. For example, an insurance contract contains provisions that extend beyond the mere return of investment results on the underlying items. To isolate one aspect of the overall contract requires the decomposition of the contract. We believe this decomposition results in complexity and arbitrariness similar to that which the Board noted for separating a contract that is deemed to be an integrated arrangement within the context of the insurance contracts standard. If the Board decides to proceed with the mirroring approach, we believe revisions will be necessary to explain how to separate the cash flows. We are not confident that such changes will result in a mirroring approach that is sufficiently transparent, comparable and not subject to a significant degree of arbitrariness.

The Board may therefore consider dealing with participating contracts without decomposing the cash flows. We suggest the Board considers using the building block model for all participating contracts, and provides specific guidance on how to determine the discount rate. We describe this further in our response to Question 2 in Appendix A.

For participating contracts that do not qualify for the mirroring approach, the Board proposes to use the building block measurement model with an update of the discount rate for interest accretion in profit or loss for those cash flows that vary directly with the underlying items. Whilst we agree with the Board's rationale in seeking to update the discount rate when expected future cash flows to policyholders change on the basis of changes in the underlying items, we have concerns on how this concept should be applied under the proposed guidance in the ED. For example, the requirement to update the interest rate in profit or loss for some components, but not for others, results in decomposition issues that are similar to those we identified for the mirroring approach (see above).

We believe the approach we suggest in our response to question 2 in Appendix A could be applied to all participating contracts, i.e., both for those that do and those that do not qualify for the mirroring approach. This would avoid having multiple models based on bright line criteria and would result in a consistent basis for both participating and non-participating contracts.

Unlocking the Contractual Service Margin (CSM)

As noted in our 2010 comment letter, we believe that the CSM should not be 'locked in' on initial recognition. Although we conceptually agree with unlocking the CSM, as set out in the proposal, we have some concerns about which changes in cash flows result in the unlocking of the CSM. For example, the ED and its illustrations do not provide sufficient guidance to determine which changes in cash flows result from changes in future cash flow expectations and which relate to changes in current period experience. Without sufficient guidance, we believe that diversity in practice on the application of CSM unlocking could emerge, resulting in a lack of comparability of reported profit between insurers.

The Board proposes not to unlock the CSM for changes in the risk adjustment. The risk adjustment measurement interacts with the potential variability in future cash flows. Therefore, we believe having changes in the future cash flows impact the CSM whilst changes in the risk adjustment flow though profit or loss is inconsistent. We do agree that disaggregating the overall change in the risk adjustment in each period into a portion that relates to the current period and one that relates to the future would come with challenges. However, we believe it is important to treat the components of the movement in liabilities relating to future coverage consistently, regardless of whether they relate to the estimate of future cash flows or the risk adjustment on those cash flows.

Insurance contract revenue

We agree that the introduction of an insurance contract revenue measure based on the proposed 'earned premiums' approach for all contracts would bring consistency with the proposed revenue recognition model for other industries, both in how it reports premiums as revenue over time, and in which elements of premiums are reported as revenue. Within the building block model, the earned premium approach introduces a revenue measure for contracts that may contain a significant investment component measured on a current value basis not dissimilar to the fair value basis used to measure certain financial instruments under IFRS 9. Even though the Board proposes to eliminate the investment component from the reported revenue figure in a practical way, we question whether an allocated customer consideration approach produces a meaningful revenue figure for a contract with a significant investment component measured on a current value basis.

We believe that a summarised margin presentation would offer a reasonable presentation approach for contracts accounted for under the building block approach. Whilst this would result in companies not recognising revenue for contracts under the building block approach, it would, at least, present a simple and understandable approach. Traditional volume measures like premiums due, and claims and benefits, could be shown through note disclosures to the financial statements.

Notwithstanding the preference for a summarised margin approach, if users express the view that an earned premium figure would be useful to them, the Board should evaluate whether the additional benefits from providing such a figure outweigh preparers' costs of calculating this amount.

We acknowledge the fact that using a summarised margin presentation would result in the use of two different presentation models under the standard, notably the summarised margin approach for contracts accounted for under the building block approach and an earned premium approach for contracts accounted for under the simplified model (premium allocation approach). This would create some incomparability and inconvenience for composite insurers, but the other insurance contract revenue alternatives explored by the Boards thus far would not resolve this issue either. To the extent that this creates different presentations in the Statement of Comprehensive Income, the Board could investigate dealing with those different presentations through disclosures.

Transition

Measurement and CSM

We agree with the Board's proposals to include a CSM representing unearned profit in existing insurance contracts on transition to ensure that the treatment of business written before transition is consistent with that of business written after transition. We also agree that the introduction of simplifications is necessary, because preparers may conclude in many cases that it is not practicable to apply the general retrospective approach to some portion of their existing policies. We have some concerns regarding the Board's decision to select a retrospective approach with simplifications where applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* is considered impracticable.
We believe the transition guidance could create additional complications for auditors given the subjective nature of this guidance. The IASB acknowledges in the introduction to the ED that some aspects of the estimates on transition may not be verifiable. As a result, auditors would be charged with validating management's view on unearned profit at a date in the past based on information that may have been obtained from sources that were not previously captured in the audit process and/or may have been maintained outside the data subject to the company's internal control procedures.

Effective date

We agree with the Board that insurers will need a reasonable amount of time to implement the necessary changes to their processes and systems to be able to produce accurate and timely financial information under the new standard. We believe that a minimum of a three-year period after the issue of the revised IFRS 4 standard will be necessary.

The transition guidance provided by the Board would allow companies impacted by the insurance contracts standard to revisit the classification of their assets accounted for under IFRS 9 if the implementation of the new insurance standard were to create an accounting mismatch. We would prefer to have the effective dates for the insurance contracts standard and the revised IFRS 9 aligned in order to avoid companies having to go through two rounds of changes. However, we do not think the Board should delay the effective date of IFRS 9 solely to be in alignment with the effective date of the insurance contracts standard.

Consideration and incorporation of recent field testing results

As we have previously noted, potential financial statement volatility that is created by the application of the proposed standard is a significant concern for insurers. Very recent field testing by several North American insurers has highlighted these issues and also that a significant contributing factor to that volatility is the use of observable points along a market yield curve that may be viewed as not being represented by a deep and liquid market when determining the discount rate. Before the Board proceeds to a final standard, we recommend that it carefully considers the results of this useful field testing, as well as the results of any other field testing that is or has been performed by insurers in other geographic areas. That consideration should include evaluating the results with industry representatives and with

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users of insurers' financial statements to determine whether the application of the proposed standard produces financial results that are consistent with the Board's overall objective and produces decision-useful information for users of such financial statements.

The Board has limited the questions asked of respondents to five specific topics mentioned in the ED. After considering the changes made to the 2010 ED, the Board concluded these five topics are the most important. We agree that these five topics are crucial areas of the proposal in the ED. Consequently, we focus the responses in our comment letter on these five topics in order to help the Board to resolve the conceptual and application issues around these topics. Notwithstanding this focus in our letter, the proposal in the ED may contain other items, such as drafting issues that will emerge as in-depth discussions take place around the application. During the Board's redeliberation period, companies, users and others may seek further practical understanding of the requirements in the ED. We therefore believe that once the Board finalises the concepts, it should allow for a review period which enables companies, users and others to assess the clarity of the guidance in the draft standard.

Our responses to the questions in the ED are set forth in Appendix A to this letter. Our letter to the FASB has been attached as Appendix B and includes responses to a variety of questions about the overall proposed insurance contracts standards. We believe the observations and concerns included in that letter may be useful for the IASB when re-deliberating its proposal.

Should you wish to discuss the contents of this letter with us, please contact Richard Lynch at +1 212 773 5601.

Yours faithfully

Ernst + Young Global Limited

- Appendix A: Responses to specific questions raised in the Exposure Draft, *Insurance Contracts*
- Appendix B: EY's letter to the FASB's Proposed Accounting Standards Update, *Insurance Contracts*

Appendix A

Responses to specific questions raised in the Exposure Draft *Insurance Contracts*

Question 1—Adjusting the contractual service margin *Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows if:* *a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and* *b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?* *Why or why not? If not, what would you recommend and why?*

Comments:

As set out in our 2010 comment letter, we agree with the principle of unlocking of the contractual service margin ('CSM') for changes in future cash flows. We also agree with having a floor of zero and not having a limit on the maximum amount ('ceiling'). However, we believe that previous period incurred losses recognised in profit or loss due to the application of the floor of nil should be reversed through profit or loss before the CSM is replenished. Using a floor without a ceiling will align the insurance contract unearned profit concepts with the similar concepts included in the new revenue recognition guidance. In that guidance, a loss will be recognised under IAS 37 only when the profit in the contract has been reduced to nil and the contract is considered to be onerous.

We agree that the objective relating to unlocking the CSM should result in a liability that is the 'remaining unearned profit' expected from the future cash flows and services between the insurer and contract holder/beneficiary. In other words, the CSM should reflect the remaining unearned profits that flow from the expected consideration and the outflows to fulfil the obligations under the portfolio of contracts, as well as the related risk adjustment. Consequently, the CSM should not reflect profits the insurer expects to earn through sources that are not part of the measurement of the insurance contracts (e.g., an interest rate spread between earning on investments and accretion of interest on the insurance contract portfolios).

The impact of CSM unlocking depends on whether portfolios are maintained on an open basis or closed basis. An open portfolio combines previous period contracts with current period contracts, which allows expected profits from the current period contracts to offset losses that might arise from the prior year contracts. We recommend that, if the Board believes an open portfolio is acceptable, the guidance should be clarified and additional guidance will be needed to explain how an open portfolio should be applied in relation to the Board's definition of a portfolio and on unit of account.

We note that the ED indicates that, at initial recognition, the unit of measurement is at a portfolio of contracts level. However, we believe the ED includes conflicting guidance regarding the unit of account for the CSM after initial recognition. Specifically paragraphs 32 and B37(d) could be read as indicating that the unit of account should be set at a more granular level than the portfolio level referred to in paragraph 28.

In addition, paragraph B36 indicates that the same present value of cash flows will be arrived at whether determined at portfolio level or by the aggregation of cash flows at the individual contract level. We do not believe this is necessarily true with respect to the CSM. Insurance is based on spreading the risk of individual contracts through assembly of portfolios of multiple contracts. The amount of CSM release may therefore differ depending on whether the total CSM is determined at the portfolio level or as an aggregation of CSMs at a more granular level (e.g., vintages or perhaps even individual contracts). Therefore, the Board may have assumed companies might initially allocate and subsequently reallocate a portion of the CSM at a more granular level than the portfolio for recordkeeping, but for the purpose of releasing the CSM over time, insurers would base the amortisation on the entire remaining CSM and would not simply recognise the entire amount allocated to a particular contract if that contract terminated during the year. We suggest that the Board clarifies the application of CSM unlocking in the guidance accompanying the final standard.

We have identified four other areas that, without further guidance, could result in diversity in practice in how the CSM is established and released over the coverage period. Whilst we acknowledge that including further guidance in the standard could restrict the application of the principle somewhat, we believe it would make the Board's intentions clearer and achieve better consistency.

- How should increases in the CSM be accounted for following periods where the CSM was reduced to zero?
    - The ED does not explicitly mention how a company should account for favourable changes in future cash flows when it previously recognised losses in profit or loss because the unlocking of CSM was limited (i.e., the CSM cannot be negative). We

think that insurers could first reverse the losses previously recognised through profit or loss before re-instating the CSM. However, the guidance, as currently drafted, implies that the CSM is reinstated without regard to those prior losses. We believe the Board has drafted the guidance in this manner because it would simplify the application of unlocking. We believe that first reversing any previously recognised losses would prevent the total CSM reported in profit or loss from exceeding the actual profit in the contract. This approach would, in our view, also achieve better consistency with the treatment of onerous contracts within the context of the revenue recognition proposals. Regardless of which approach the IASB selects, we believe the Board should clarify this by providing guidance on how to treat favourable changes following periods where losses have been recorded in profit or loss.

- When are current period changes in assumptions that impact future coverage recognised in profit or loss rather than being offset against the CSM?
  - The Board proposes that the CSM should only be unlocked for changes in estimates of future cash flows that relate to future coverage. We are unable to determine from either the application guidance or the illustrative examples how to unlock for an event that happens in the current period that also causes a change in future expected cash flows for the existing portfolio of insurance contracts (often referred to as in-force business). For example, the expected present value of net future cash flows would be impacted by a large number of policyholder lapses as cash inflows and outflows (presumably due to future coverage) would no longer be received and incurred respectively. We believe the Board intended to state that the effect of events in the current period (e.g., fewer lapses than expected) on future cash flows from the in-force contracts be recorded in profit or loss in the current period and should modify the guidance to make this clearer. For example, how does unlocking of the CSM for estimates of future cash flows interact with the derecognition of contracts (e.g., once the coverage period has ended or other termination of the contract).

- Can there be multiple services in one insurance contract?
  - In the ED, the Board requires that an insurer release the CSM over the coverage period in a way that best reflects the pattern of transfer of services (other than bearing risk) to policyholders under the contract. This guidance seems to assume that the insurance contract only has one service and does not address how the CSM should be allocated if there are multiple services. We recommend that the guidance be modified to specifically address insurance contracts that contain multiple services that are not distinct.

- How to treat asset management fees within the CSM?
  - Paragraphs B68(d) and B68(e) seem to contradict each other on whether changes to insurance contract liabilities from movements in underlying items which relate to future asset management services should be adjusted against the CSM. Also,

the ED does not address how participating features designed to compensate for asset management services should be treated.

Risk Adjustment

The Board proposes that all changes in the risk adjustment should be recorded in profit or loss and paragraph BC 37 provides the Board's reasoning for that decision. We believe that the measurement of the risk adjustment will, to some extent, be based on the potential variability in the future cash flows. Whilst determining the risk adjustment comes with challenges, it seems inconsistent to require changes in expected cash flows relating to future coverage be offset against the CSM whilst changes in the risk adjustment relating to risks for future coverage flow though profit or loss. For example, if the future expected cash flows increase and the overall uncertainty in those cash flows decreases, the proposal would reduce the CSM for the increase in future cash flows (no profit or loss impact for higher expected future cost) whilst the risk adjustment would decrease and thereby create income in profit or loss. We question whether the financial statement impact of this example (showing earnings whilst, at the same time, increasing the insurance liabilities) is a fair representation of the economics.

The IASB explains in the Basis for Conclusions that the decision to record the change in risk adjustment through profit or loss is partly based on a belief that most of the change in the value of the risk adjustment would relate to expiry of coverage. This contention may not always be true. Consider an example where the population of potential outcomes narrows, causing the risk adjustment to be reduced significantly at the end of a reporting period. Here, a large proportion of the change in the risk adjustment would relate to re-assessment of the uncertainty in the remaining future cash flows rather than to the expiration of coverage.

Question 2—Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:
a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?
b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (ie using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?

c) recognises changes in the fulfilment cash flows as follows:

i. changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;

ii. changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and

iii. changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

Why or why not? If not, what would you recommend and why?

Comments:

The building block approach applies the fundamental principle that the measurement of the insurance contract portfolio is independent of the assets held, unless the fulfilment cash flows of the insurance contracts depend wholly or partly on those assets. When there is such dependence, the measurement of the insurance liability should reflect the extent of that dependence. We agree that the Board follows the concept that when an arrangement transfers the specific investment risk of assets held to another party (e.g., the policyholder), the financial statements provide relevant information if the measurement of the portion of the values of the assets held agrees with the measurement of the obligations created by the arrangement.

We therefore understand the Board's rationale for proposing an exception (i.e., measurement and presentation exception based on 'mirroring' the measurement and presentation of underlying items) to the basic model. We believe the mirroring approach is, conceptually, a way to achieve the Board's goal to eliminate accounting mismatches where an economic mismatch cannot exist for (a portion of) the contract's cash flows. However, if the Board wishes to pursue the mirroring approach, we believe the Board would have to revisit and, where necessary, modify the mirroring proposals on the areas discussed below.

Insurance contracts have many aspects to them and the Board's proposed solution within its mirroring exception guidance requires decomposition of the cash flows of the insurance contract into separate categories: those that vary directly with underlying items, those that vary indirectly with underlying items and those that do not vary with underlying items (some of which are dependent on each other). This approach results in an insurance contract having to be decomposed for measurement and presentation purposes, similar to the separation that is required for embedded derivative or distinct investment and service components[1]. In the Basis for Conclusions, the Board explains the rationale for prohibiting the separation of insurance components for non-distinct investment and service components by noting that such separation would be arbitrary and, thus, reduce transparency and comparability. We think that this rationale can be applied equally to the requirement to split cash flows relating to participating contracts to apply the mirroring approach. We note that the IASB provides some guidance in paragraphs B 85 and B 86, but this guidance is difficult to understand and we think companies would struggle in applying this guidance in a meaningful way to even fairly straightforward contracts. If the Board were to proceed with the mirroring approach, we believe further guidance will be necessary on how a company should allocate the cash flows between categories.

Further, the scope of contracts to which this exception applies could be considerably smaller than the Board had expected. For example, certain common unit-linked arrangements may not meet the scope requirements in some jurisdictions. We understand that the Board developed the scope for the purpose of eliminating accounting mismatches only in situations where an economic mismatch cannot exist. We believe criteria to widen the scope to capture a larger population of participating contracts will be challenging within this context. As a result, we believe that contracts that the Board had expected would be able to apply the mirroring approach are excluded by this bright line requirement. If the final standard retains this measurement and presentation exception, the mirroring guidance should include more examples on types of contracts to which the mirroring approach applies.

In addition, we believe that the guidance on how to apply the mirroring approach would require further clarification and/or expansion on the following areas:

- How will any future changes to IFRS 9, for example, new impairment and macro hedging models, interact with the insurance contracts standard?
- How should mirroring be applied if the underlying item is not a basket of underlying items but the profits of the company as a whole?
- What is the impact of local accounting standards when those standards are the basis for determining the contractual profit sharing amounts (e.g., XYZ Country GAAP is the basis for determining the benefit payments, not IFRS)?
- Are cash flows that are subject to discretion included in mirroring accounting? The wording of paragraph B84(a) needs to be clarified to express the Board's intention.
- How does the model work if the policyholder pays periodic premiums and the balance of the underlying items that are to be 'mirrored' build up over time?
- How are asset management fees allocated under the proposal – are they allocated across categories of cash flows or are they included in only one of the categories?

We are not confident at this stage whether the Board will be able to revise the mirroring approach so that it can be applied in a way that is transparent and comparable and not

[1] Separate one or more components from a 'host' insurance contract and account for those components in accordance with those components according to applicable IFRSs, as if they were stand-alone contracts.

subject to a significant degree of arbitrariness. As such, the Board may need to consider dealing with participating contracts in other ways.

One way could be for the Board to revisit the scope of what constitutes a distinct investment component with the potential objective of expanding the list of components deemed distinct and separated from the host insurance contract. However, considering the Board's struggle with the topic of separation in the past, we are not convinced that re-visiting the separation guidance would be productive at this stage of the project. We therefore believe the Board should retain its current proposal in the ED on separation.

The Board could also pursue an approach based on applying the building block model to all participating contracts without requiring further decomposition of cash flows into categories. As explained in our cover letter, we believe that, within the context of such an approach, the Board should consider providing companies with the choice to reduce accounting mismatches based on their particular circumstances. We would not support having too many choices or permitting insurers to switch the method they select between periods. We believe that the main features of such an approach should be:

- Application of the building block model to a bundle of cash flows from insurance contracts at the portfolio level, without further decomposition of cash flows. Applying the model to an undivided bundle of cash flows means a company would have to use one liability discount rate curve for all future cash flows from a portfolio of contracts. Under the Board's principle that the discount rate should reflect the characteristics of the insurance liability, a company may therefore have to use a practical expedient (e.g., a blended discount rate) as an approximation for applying liability discount rate curves for each type of cash flows based on the particular characteristics of those cash flows (e.g., participating or non-participating).
- An irrevocable choice to recognise the effects of changes in discount rates in profit or loss instead of OCI, elected at inception on a portfolio-by-portfolio basis. This option would allow insurers to reduce or eliminate accounting mismatches if their assets are not at FVOCI.

We acknowledge that applying the building block model to all contracts, including participating contracts, with a practical expedient for discount rates and an option to recognise the effect of changes in discount rates in profit or loss reflects, to some extent, a practical compromise that still does not solve all possible accounting mismatches. However, this would, in our view, be a justifiable simplification with the possibility to prevent most accounting mismatches without the need to resort to the complexities inherent in the mirroring approach. Moreover, as we consider the measurement model, we are continuously reminded that insurance contracts can be a complex amalgam of financial, pure risk and service-type components. Finding the perfect sole solution for such contracts is unlikely. Therefore, a compromise based upon a common measurement and presentation basis will be necessary to progress this project to completion.

Question 3—Presentation of insurance contract revenue and expenses

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

Why or why not? If not, what would you recommend and why?

Comments:

We acknowledge that the notion of insurance contract revenue ('earned premiums') brings consistency with the revenue recognition model for all types of insurance contracts, both in how it reports premiums as revenue over time and what elements of premiums are reported as revenue. At the same time, application of the approach would be a dramatic change from recognising revenue on the basis of premiums due, as applied under most existing life or long-term insurance contract standards.

We agree with the Board that application of 'earned premiums' would only be consistent with the general revenue recognition proposals if non-distinct investment components are disaggregated for presentation purposes. We understand the Board may have intended this disaggregation to be applied in a simple, practical manner (by simply deducting from the 'gross' earned premium the surrender value for all policies lapsed in the period). Nevertheless, preparers and users may question why the contract is not separated for measurement purposes, but then the cash flows of investment components are disentangled for the purpose of income statement presentation. This dilemma highlights that the earned premium model, as an allocated customer consideration approach, may not produce useful information for contracts with a significant investment component that are measured on a current value basis.

We believe that the Board's ultimate decision on how to report revenue in comprehensive income should be based on what the users of financial statements value when analysing companies' financial performance. Therefore, the main rationale should be whether the users think 'earned premiums' is a useful depiction of performance from insurance contracts within the financial statements, and whether the additional benefits from presenting insurance contract revenue on a basis consistent with other entities outweighs the cost of preparing this amount.

If producing the earned premium would be too difficult or the users would not support the approach for contracts accounted for under the building block model, we believe the summarised margin presentation for the building block approach in the Statement of Comprehensive Income may be the only option available. Whilst this would result in companies not recognising revenue for contracts under the building block approach, it would

at least present a simple and understandable approach that avoids revenue amounts that are inconsistent with the general revenue recognition model. If the Board were to select a summarised margin presentation for contracts under the building block approach, it would need to consider whether a specific disclosure requirement for volume information is necessary.
We would not support using any other insurance contract revenue approach explored by the Board thus far, because other alternatives considered are not consistent with the principles of revenue recognition and would therefore not bring comparability.

We continue to support the use of earned premiums as insurance contracts revenue for those contracts accounted for under the simplified measurement approach. While we understand this would create some incomparability and inconvenience for composite insurers, other insurance contract revenue alternatives explored by the Boards thus far would not resolve this issue either. The Board could consider resolving this presentation difference through disclosures.

Question 4—Interest expense in profit or loss

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:
(a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and
(b) recognising, in other comprehensive income, the difference between:
the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and
the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

Why or why not? If not, what would you recommend and why?

Comments:

The use of OCI is consistent with the fulfilment value measurement objective for insurance contracts. It is also consistent with the Board's proposal to introduce a FVOCI category in IFRS 9. The use of OCI for presenting the effect of changes in discount rates will avoid accounting mismatches for debt instruments accounted for at FVOCI. The use of OCI does not resolve accounting mismatches when a company holds investments that are not at FVOCI (i.e., real estate, derivatives, private equity funds, etc.) to provide funds to fulfil the obligations created by insurance contacts. Rather, the mandatory application of OCI to insurance liabilities may introduce accounting mismatches for such instruments.

A possible solution for this accounting mismatch would be to give companies the choice to record the effect of changes in discount rates on their insurance liabilities in profit or loss, rather than to require the use of OCI for insurance liabilities. The disadvantage would be increased optionality and less comparability, although we believe this would be outweighed by the benefits of avoiding accounting mismatches and the possibility to simplify other areas of the proposal (we refer to our response to question 2). We recognise that optionality of the use of OCI on the liability side may not completely resolve the accounting mismatch issue as some assets cannot be measured at fair value through profit or loss under applicable IFRSs.

Insurance contracts that offer a link to investment results, but the mirroring approach does not apply

For participating contracts that do not qualify for the mirroring approach, the Board proposes to use the building block measurement with an update of the discount rate for interest accretion in profit or loss for those cash flows that vary directly with the underlying items. Whilst we agree with the Board's rationale to update the discount rate when the expected future cash flows to policyholders changes on the basis of changes in the underlying items, we have questions related to the application of this concept.

A consequence of updating the discount rate for interest accretion in profit or loss would be the need to distinguish cash flows that vary directly with the underlying items from other cash flows. This requires a decomposition of cash flows similar to the decomposition that needs to be applied for contracts that qualify for the mirroring approach (see BC 130 and BC 131). This would, in our view, result in similar complexity as observed for contracts that are subject to 'mirroring'. We therefore believe our suggested approach set out in our response to question 2 should be applied to all participating contracts, i.e., both for those that do and those that do not qualify for the mirroring approach.

For cash flows of a contract that are expected to vary directly with returns on underlying items, paragraph 60(h) requires companies to update the discount rate for determining the interest expense in profit or loss when the expected future cash flows change as a result of a change in the expected returns from the underlying items. In our view, the guidance in paragraph 60(h) is not sufficiently clear on how to apply this update. Based on this wording, the trigger point seems to be a change in returns on underlying assets changing expectations for future payments to the policyholders. Further, the wording seems to suggest any update is referenced to the market interest rate in effect at the time of the update.

The intention of the Board may have been to indicate that when the fulfilment value cash flows are changed to reflect returns expected to be passed on to the policyholder, the rate for interest accretion needs to be adjusted. If this were the Board's intention, we believe it should clarify the wording of paragraph 60(h) to say the rate for interest accretion is updated to reflect the changes in expected future crediting rates. This would result in the insurance contract liability measurement being similar to a variable debt instrument. The crediting rate for determining the expected future payments to policyholders may depend on the returns (yield) on underlying assets currently held by the insurer and the expected returns on future reinvestments. The ED should provide guidance on how this should be reflected in the rate for interest accretion.

The requirement to present changes in expected future cash flows as a result of changes in the underlying items in profit or loss according to paragraph B68(d) could result in accounting mismatches when the underlying assets are held at FVOCI.

Question 5—Effective date and transition

Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

Why or why not? If not, what do you suggest and why?

Comments:

We agree with the Board's proposals to include a CSM on transition. However, we have some concerns regarding the Board's decision to select a retrospective approach with simplifications if applying IAS 8 is impracticable. Many preparers may conclude it is not practicable to apply the general retrospective approach to some portion of their existing policies in-force. We therefore agree that the introduction of simplifications is necessary. Two areas where we believe the modified retrospective methods need clarification are:

i. Unit of account: upon transition, the company may apply the retrospective approach fully to some portfolios and use the practical expedient for other portfolios. Further, companies may have portfolios that contain some individual contracts where a full retrospective approach is applied and others where the practical expedient is applied. The Board should therefore consider only permitting the option to select the use of the simplified transition approach to individual portfolios and require disclosure on such an election.
ii. Lack of historical data: the transition guidance allows companies to use the actual cash flows that occurred in the years before transition in estimating the margin at inception. However, in some cases, companies will not have all historical cash flows. Using incomplete historical cash flows means the estimate of the CSM would be based on an incomplete picture of cash inflows and cash outflows. Comparing an incomplete set of cash flows could result in a figure that has limited value. Since situations where a company is unable to retrieve a part of the historical actual data may not be uncommon, the Board should provide guidance on how a lack of historical data should be considered when estimating the CSM.

The transition guidance could create additional complications for auditors given the subjective nature of this guidance. Further, the IASB acknowledges in the ED that some aspects of the guidance may not be verifiable, including the discount rate and CSM applied at transition. For example, auditors would be charged with validating management's view on unearned profit at a date in the past, based on information that may have been obtained from sources that were not previously captured in the audit process and may have been maintained outside the data subject to the company's internal control procedures.
We agree with the Board that insurers will need a reasonable amount of time to implement the necessary changes to their processes and systems to be able to produce timely financial information. We believe that a minimum of a three-year period after the issuance of the revised IFRS 4 standard will be necessary.

We agree with the transition guidance that provides companies with the ability to redesignate their assets accounted for under IFRS 9 if the implementation of the new insurance standard would create an accounting mismatch. We would prefer to have the effective dates for the insurance contracts standard and the revised IFRS 9 aligned in order to avoid companies having to go through two rounds of change. However, we do not think the Board should delay the effective date of IFRS 9 solely to be in alignment with the effective date of the insurance contracts standard.

Question 6—The likely effects of a Standard for insurance contracts

Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5?
How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft?

Please describe the likely effect of the proposed Standard as a whole on:

a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and
b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.

Comments:

As currently formulated, the standard would significantly reduce the inconsistencies in insurance accounting globally as many countries rely on local standards. The proposed standard would affect all companies from an earnings emergence perspective. The greatest impact for the industry will be on life insurers given the duration of their contracts. However, general insurers will have their own challenges as they will need to discount their liabilities for incurred claims, including the application of OCI for the effect of changes in discount rates.

As we have noted throughout our comment letter, the revised proposal includes several areas that would cause complexity. Companies would have to expend significant resources to initially adopt the proposals and to continue to apply them on an ongoing basis. Normally, when an accounting standard is updated, all companies have costs that are somewhat comparable. However, the current IFRS 4 is not a comprehensive model and the cost for companies to implement any update to IFRS 4 will be impacted by the information that they maintain today to prepare their financial statements. Some companies' costs may differ significantly from other companies' costs, and mid-size to smaller insurers may be more likely to have costs that will exceed the benefits.

We have not performed an analysis to assess the costs of implementing the proposed ED against the increased benefits of more decision-useful information. However, the cost to implement the proposal without any modifications may exceed the benefits due to the complexity in some areas of the ED. We believe if the Board considers the changes we suggest to simplify the proposal, the costs to implement should be at a level that is reasonable within the context of a new insurance contracts accounting standard that brings a consistent solution for the longer term.

Question 7—Clarity of drafting

Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB?

If not, please describe any proposal that is not clear. How would you clarify it?

Comments:

We support the IASB's objective to prepare a principles-based standard. However, this poses the challenge to establish a balanced set of overarching principles with relevant application guidance. We do not think the ED achieves this balance in all cases; for some areas, the guidance is fairly high-level and for other areas, it is fairly detailed and prescriptive.

One specific area where we have considerable difficulty in understanding the intended application of the ED is the guidance on participating contracts, for both the measurement and presentation exception under the mirroring approach (paragraphs 33, 34 and 66) and the update of the discount rate for determining the expense in profit or loss in case the mirroring approach does not apply (paragraph 60h). We believe the guidance requires significant improvement, particularly if the Board intends to retain the mirroring approach.

Related to the previous point, the Board needs to clarify the application of the ED to options and guarantees measured under the insurance model:

- The ED is clear on how to measure such options and guarantees: a current value, considering a range of scenarios (i.e., stochastic).
- The wording in the ED is, in our view, also clear on how to present changes in options and guarantees embedded in contracts to which the mirroring approach is applied: all changes in the value of the guarantee would be presented in profit or loss, including both changes in expected future cash flows and the effect of discounting. However, the wording in the ED is not clear on whether this would relate to both the intrinsic value and the time value of the guarantees.
- The ED is not explicit on how to present changes in embedded derivatives in contracts where the mirroring approach is not used. We believe the Board's intention is that for those contracts the change in the value of the derivative would have to be disaggregated according to the general model, notably with some elements presented in OCI, some elements presented in profit or loss, and some elements adjusted against the CSM.

The Basis for Conclusion (BC127(b)) appears to suggest the Board intended a different application depending on whether such a derivative is included within a contract that is treated under the mirroring approach. We are concerned about the complexity associated with isolating the changes in the value of options and guarantees from other measurement changes under the mirroring approach. We are also concerned about the potential diversity as a result of having different treatments for options and guarantees that are very similar.

Other topics

Comments:

In addition to our responses to the specific questions in the ED, we have the following comments.

Directly attributable acquisition cost

We prefer an approach that includes only directly attributable acquisition costs related to the entity's selling efforts that result in obtaining the contracts in the portfolio (that is, those costs for successful contracts). All other acquisition costs should be recognised as expenses when incurred.

We agree that a practical expedient to allow entities to expense all acquisition costs when incurred (accrued or paid in cash) for contracts measured using the simplified measurement approach should be included, and we recommend that the Board considers expanding the practical expedient to a somewhat broader range of contracts measured under the simplified approach (e.g., with a coverage period of two years). Another alternative that would reduce the cost to implement this aspect of the proposal for the simplified model is to allow entities to only include incremental costs, similar to revenue recognition, in their determination of directly attributable acquisition costs. The costs to implement systems and processes to capture non-incremental costs such as underwriters' salaries and benefits and policy issuance costs for successful efforts do not outweigh the benefits gained from reporting such information.

Discount rates

Many insurance contracts have expected durations that extend beyond the period of observable market yields. Discounting cash flows expected in periods for which there are no observable data points may significantly affect the current period value of the insurance contracts and may have similarly significant effects on an insurer's financial statements. As a result, the guidance on how to determine the discount rate for that portion of the cash flows is a critical aspect of the proposal. The guidance included in paragraph B71 is unclear with respect to how insurers should estimate the discount rates for those periods. That guidance first states that an estimation technique could be used, but then also indicates those rates could be determined using the current, observable market yield curve for shorter durations. To clarify what we believe was the Board's intent, the Board should consider incorporating into paragraph B71 language similar to the observation in paragraph BCA81. That observation states that forecasts of unobservable inputs tend to put more weight on longer-term estimates than on short-term fluctuations.

We expect that most companies that would need to apply the simplified model will have insurance liabilities whose characteristics generally will not include any risk associated with assets, so starting with a risk-free rate and adding a liquidity adjustment may be preferable. Weighing the costs of determining a liquidity adjustment versus the benefits, the Board should consider allowing companies, especially those applying the simplified model, the option to use the risk-free rate for discounting its liabilities. We believe this option should be irrevocable and be used for all portfolios of contracts accounted for using the respective approaches; that is, for all contracts measured using the simplified model or for all contracts measured using the building block approach.

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Appendix B

Ms. Susan M. Cosper
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Financial Accounting Standards Board
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28 October 2013

Proposed Accounting Standards Update, *Insurance Contracts*
(File Reference No. 2013-290)

Dear Ms. Cosper,

We appreciate the opportunity to comment on the Proposed Accounting Standards Update, *Insurance Contracts,* (the proposed Update) from the Financial Accounting Standards Board (FASB or Board).

We continue to believe that creating a single set of high-quality global accounting and financial reporting standards is important and we strongly support the convergence of US GAAP and IFRS. However, on the proposed guidance for insurance contracts, the FASB and the International Accounting Standards Board (IASB) (collectively, the Boards) have not been able to fully converge their proposals. We believe the Boards have made significant progress addressing the concerns raised by constituents about the FASB's 2010 Discussion Paper and the IASB's 2010 Exposure Draft. We encourage the Boards to continue to work together to minimize differences in their insurance contracts proposals and make them more comparable.

However, we recognize the Boards are in two different situations. US GAAP has comprehensive accounting standards for insurance entities and, therefore, the FASB should focus on improving existing US GAAP. In contrast, IFRS 4 does not comprehensively address accounting for insurance contracts and permits a wide range of practices. Therefore, the IASB should focus on issuing a revised IFRS 4 standard as soon as it can. Because of this, it may be necessary for the Boards to re-deliberate aspects of their proposals separately. However, we believe the Board should consider re-deliberating as many areas as possible with the IASB. We recognize that the Boards will not re-deliberate jointly in all areas which will result in some conceptual differences between the FASB's guidance for insurance contracts and that of the IASB. In some instances, we believe both approaches are conceptually sound, and while we prefer a converged standard, we do not object to some of those differences.

We also recommend that the Board form a working group to address implementation issues during the redeliberation process. We believe this will help ensure consistent interpretations and application of the guidance and will minimize implementation issues that could result in the Board needing to revisit certain aspects of the final guidance.

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We summarize our most significant concerns with the proposed Update below. Appendix A to this letter contains our detailed responses to selected questions in the proposed Update. Appendix B contains our letter to the IASB.

Scope

We agree with the principle that contracts that meet the definition of an insurance contract should be included in the scope of the proposed guidance. However, we are concerned that without modifications to the proposed definition of insurance, the population of arrangements that would be required to use the guidance would be too broad.

We believe the Board needs to more clearly articulate the difference between a financial risk and an insurance risk and clarify when compensation paid to another party fulfills an entity's own performance obligation. Clarifying the proposed guidance would also reduce the need for many of the proposed scope exclusions. We find those exclusions confusing, detract from the definition of insurance and note that they would need to be updated as new products are developed and issues arise. While we recognize that there still will be a need for some explicit scope exclusions, we believe the Board should focus on characteristics of contracts rather than specific examples, where possible.

We also believe the Board has not adequately explored the various arrangements that are currently accounted for under other accounting guidance but would fall within the scope of the proposed guidance. We are particularly concerned about arrangements currently in the scope of ASC 460 on guarantees. The accounting for these arrangements should be addressed on a comprehensive basis if it is to be changed. Without a detailed analyses and a broader awareness by preparers that issue these types of arrangements, the resultant accounting may not adequately address these arrangements.

The proposal indicates that insurance must cover a pre-existing risk, but the Board needs to clarify this fundamental concept because it is not well understood outside of the insurance industry. By clarifying when there is a pre-existing risk, the Board could alleviate any confusion among noninsurers about whether arrangements they routinely enter into with their customers would be in the scope of the proposed standard. In addition, we believe that entities should look at the substance of the transaction in its entirety. An example is an arrangement in which the settlement of a claim triggers a simultaneous, unavoidable transaction with the party that benefits from the loss event (i.e., a stand-by letter of credit). Another example is an arrangement where the issuer of the guarantee (insurance) only compensates the contract holder if the contract holder enters into a secondary transaction (i.e., a trade-in right). We do not believe the substance of these arrangements is insurance and therefore should not be in the scope of the proposed guidance. We also believe the Board needs to clarify its implementation guidance on when an arrangement is an insurance contract.

One or two models

We have a conceptual preference for one model, but we agree with the Board's decision to include two models due to the differences in insurance contracts and how those contracts are viewed by users of financial statements. However, we believe the principles in the two models should be consistent. For the most part, the premium allocation approach, once the coverage period ends, and building block approach are converged. The recognition of the profit is not converged and we believe it should be treated the same under both models. We do not believe the accounting differences between the two models constitute different principles, except for the recognition of the profit.

If the general principles are modified to be consistent between the premium allocation approach and the building block approach, we do not believe that the premium allocation approach should be required for all contracts that meet the criteria to apply that approach. In addition, we have concerns about the criteria that would be used to determine the required model and whether diversity in practice might result.

Discount rates

Determining the discount rates

The selection of discount rates would have a significant impact on the accounting for insurance contracts. The discount rates need to achieve a balance between providing a measurement model that fairly represents the economic relationship between the insurer and the contract holder and, at the same time, produces a liability that reflects the current expected value to fulfill the insurer's obligations. Such a rate also must provide meaningful performance measures and be consistent with the economics of the business.

We understand and agree with the Board's desire to use discount rates that are based on the characteristics of the liability, rather than the assets used to fund that liability, to provide a more consistent measurement among entities. However, using the characteristics of the liability as the basis could result in diversity in practice because views differ on what those characteristics are and/or how they should be reflected in the discount rates.

We believe that using a yield curve that reflects current market rates of returns either for a reference portfolio of assets or the entity's actual portfolio of assets is an appropriate starting point. We also believe that the yield curve should be adjusted to exclude factors that are not relevant to the liability. However, the lack of clarity in the proposed Update regarding this approach could lead to a lack of comparability.

We also are concerned that the proposal does not contain clear conceptual guidance for determining the liquidity adjustment to the risk-free rate. Where required for regulatory purposes, the calculation of the liquidity adjustment is prescriptive. Without additional guidance there would likely be diversity in practice and lack of comparability. We are also concerned that requiring the complex determination of the liquidity adjustment each period may outweigh the benefits of discounting at a higher rate.

Therefore, the Board should allow entities to discount their non-linked contracts (i.e., non-participating contracts) using either a risk-free rate or a high-quality corporate bond rate as a practical expedient. This would minimize the complexity and the costs of compliance. Although the discount rates will be different, we believe the proposed requirement to disclose the yield curves and the related expected cash flows would improve transparency and provide useful information to users of the financial statements.

As we have previously noted, potential financial statement volatility that is created by the application of the proposed standard is a significant concern for insurers. Very recent field testing by several North American insurers has highlighted these issues and that a significant contributing factor to that volatility is the use of observable points along a market yield curve that may be viewed as not being represented by a deep and liquid market when determining the discount rate. Before the Board proceeds to a final standard, we recommend it carefully consider the results of this useful field testing, as well as the results of any other field testing that is or has been performed by insurers in other geographic areas. That consideration should include evaluating the results with industry representatives and with users of insurers' financial statements to determine whether the application of the proposed standard produces financial results that are consistent with the Board's overall objective and produces decision-useful information for users of such financial statements.

Recognizing the effect of changes in the discount rates

We agree with the Board's decision to recognize the effects of changes in discount rates in other comprehensive income (OCI), even though doing so increases the complexity of the accounting. We understand that the Board's intent is to isolate the changes in underwriting from the changes in discount rates and to minimize accounting mismatches while recognizing economic mismatches. However, we are concerned that requiring the effects of changes in discount rates to be recognized in OCI for all non-contractually linked contracts may exacerbate accounting mismatches.

A significant portion of an insurer's investment portfolio includes fixed income assets and asset-backed investments, much of which are accounted for at fair value through OCI under existing GAAP. However, many of these investments may be required to be accounted for at fair value through net income under the Board's proposed guidance on financial instruments. Insurers also invest in equities, derivatives and limited partnerships that are accounted for at fair value through net income and real estate and mortgage loans that are accounted for at amortized cost, among other investments. The investment portfolio typically reflects the characteristics of the liabilities within a portfolio, most importantly the duration of those liabilities and how interest rate movements affect them. While the accounting for insurance liabilities should not be based on the types of assets that a particular insurer holds, we believe consistent measurement and presentation of changes in value of the insurance liabilities and invested assets backing those liabilities is necessary to minimize accounting mismatches. We concur with the Board that standards generally should not give entities the option to choose their accounting. However, when there is a clear rationale such as minimizing accounting mismatches, we believe policy choices can be acceptable as long as the choice is disclosed.

We believe, where possible, entities should be provided accounting options to avoid accounting mismatches. Therefore, we believe entities should have an irrevocable choice at the portfolio level to determine whether to recognize changes in discount rates in either OCI or net income. Requiring the choice to be made at the portfolio level will not eliminate all accounting mismatches but will mitigate some of the mismatches in earnings. Providing such an option would not promote comparability. But requiring the disclosure of how discount rate changes in insurance liabilities are reported would provide users with sufficient information. We believe this approach would provide users with better information than they currently receive and would align, to the extent possible, the financial reporting of companies with their asset/liabilities strategies. This alignment also would increase transparency by allowing users to understand how the business is managed.

Interest accretion rates

We agree that interest expense should be based on a locked-in accretion rate, even though doing so would make the accounting more complex. We believe this approach is necessary because of the Board's decision to recognize the effect of current-period changes in the discount rates used to value the insurance portfolios in OCI. However, the definition of portfolio is not specific as it relates to the accretion rate. We are uncertain whether the Board intended that entities would need to have closed portfolios to apply the interest accretion guidance. Although this is not stated in the proposal, accreting interest at the initial recognition discount rates, as proposed, would appear to require entities to create a new portfolio each time there is a change in discount rate. We understand that the Board did not intend to force entities to create new portfolios for the same product within a given reporting period just because they adjust their pricing in response to market conditions. Requiring multiple portfolios for the same reporting period would mean entities would need to capture an enormous amount of data to calculate the difference between the current rates and the multiple locked-in rates for each portfolio. Therefore, we propose that when a closed portfolio is used the Board consider allowing entities to use an average interest accretion rate. This practical solution would minimize the complexity and the cost of compliance.

Margin and changes in expected cash flows

We agree that, at initial recognition of an insurance contract or reinsurance contract, a gain should not be recognized because an entity has not yet performed under the contract and there is uncertainty about whether the gain will occur. We would not object to using the one-margin approach included in the proposed guidance with modification to the period over which it is recognized in income. However, we also would not object to a two-margin model under which an entity would recognize a provision for uncertainty and a residual margin.

We recognize that the proposed margin represents the amount of expected consideration (premium) in excess of the expected cash outflows and is intended to compensate the entity for several items, including accepting risk that actual benefits are greater than expected, general operating costs to run a business and an economic return to the entity's shareholders. Decomposing the excess amount into separate measurement amounts may provide relevant information if the underlying principles for those separate measurements is sufficiently clear and would result in comparability across entities. However, the costs to prepare and update may not justify a model that has more than one margin.

We do not believe there is a conceptual reason for there to be a difference in the timing of profit recognition between the building block approach and the premium allocation approach. Therefore, either the margin should be recognized over the coverage and settlement period, as proposed for the building block approach, or the margin should be decomposed into two components, a residual margin that would be recognized over the coverage period and a provision for uncertainty that would be recognized over the coverage and settlement period as the uncertainty in the cash flows decreases. For the premium allocation approach, either the liability for remaining coverage should be earned over the coverage and settlement periods or a provision for uncertainty should be recognized when a claim is incurred.

We believe that, similar to the day one measurement, the margin should reflect the "remaining unearned profit" expected from the future cash flows and services between the insurer and contract holder/beneficiary at each reporting date. In other words, the margin should reflect the remaining unearned profits that flow from the expected consideration and the outflows to fulfill the obligations under the portfolio of contracts. Consequently, we do not agree that changes in estimated cash flows (other than the effect from changes in the discount rates) should be recognized in net income. Instead, both favorable and unfavorable changes in expected cash flows (other than the effect of changes in the discount rates) should be recognized as adjustments to the margin, up to the amount of consideration expected to be received. The margin should not be below zero and therefore any excess adjustments would be recognized as a loss.

If the Board decides to adjust the margin for changes in expected cash flows, it would need to decide how the adjusted margin should be calculated. While a retrospective catch-up approach may be most theoretically sound, the complexities may outweigh the benefits and a prospective approach may be a practical solution. The Board also would need to determine whether the margin would be based on a closed or open portfolio. Our preference is a closed portfolio. In addition, the Board would have to specify what is considered a current-period experience adjustment rather than a change in expected cash flows. Without sufficient guidance about these items, we believe that diversity in the application of unlocking the margin for changes in expected cash flows could emerge, resulting in a lack of comparability of reported profit emergence among insurers.

Notwithstanding our comments above, if the Board decides that the margin determined at initial recognition should be retained for the estimation risks in the portfolio or that adjusting the margin for changes in expected cash flows adds unnecessary complexity and detracts from transparency, we would not object to recognizing changes in expected cash flows in net income. However, we believe that entities should not recognize changes in the expected cash inflows in net income as proposed. Instead, we believe that the profit included in changes in expected cash inflows that relates to extending or obtaining increased coverage should adjust the margin. The reasons for deferring expected gains on the initial expected cash flows equally applies to any additional expected cash inflows; that is, an entity has not yet performed under the contract and there is uncertainty in the insurance contract about whether the gain will occur. Also, we do not believe an entity should recognize the remaining margin when the expected cash outflows are in excess of the expected cash inflows and the qualifying acquisition costs.

As previously noted, we also would not object to a two-margin approach under which an entity would decompose the amount of expected consideration (premium) in excess of the expected cash outflows into a provision for uncertainty (if it provided useful information) and a residual margin. However, we are concerned that a provision for uncertainty could become a standardized add-on to the mean, or a way for management to inject bias into the measurement process. Further, we continue to be concerned about the reliability of estimating a provision for uncertainty. Therefore, if a two-margin approach is adopted, we believe the objective of the provision for uncertainty needs to be clearly defined, the provision for uncertainty and diversification benefits for claims yet to be incurred should be calculated at a portfolio level and specific disclosures should be required about the techniques used and assumptions to calculate the provision for uncertainty.

Revenue recognition and presentation

Consistent with current reporting, we believe that users would obtain relevant information if insurance contract revenue and expense amounts were presented in an entity's financial statements. We do not believe there is a conceptual reason for a difference in the presentation of the consideration received (revenue) for an insurance contract and other types of services or the costs to provide the contract or service (costs of goods sold). However, due to the complexities of the proposed revenue recognition approach, we believe either an earned premium or summarized margin presentation could be used to present information in the statement of comprehensive income for contracts accounted for using the building block approach. While a summarized margin presentation would result in companies not recognizing revenue for contracts under the building block approach, it would at least present a simple and understandable presentation. Traditional volume measures like premiums due, claims and benefits could be shown through note disclosures to the financial statements. In making its determination, the Board should focus on which presentation provides the most useful information to all users of financial statements.

We agree with the Board that the current practice of recognizing revenue based solely on when the contract says payment is due is not appropriate because it does not consider when services are performed by the entity and it is inconsistent with the definition of revenue and how all other industries recognize revenue.

We agree with the proposal to recognize revenue over time for contracts measured using the building block approach. It is consistent with the premium allocation approach and the proposed revenue recognition model for other industries, both in how it reports premiums as revenue over time and the elements of premiums that are reported as revenue. However, we believe the Board should clarify what it means by "value of services", how it views the service that is being provided and its intent for how revenue should be recognized. This will help avoid non-comparable results for identical products/services due to diversity in interpretations.

We recognize that both the earned premium and summarized margin presentation will not convey the same volume (premium and claim) information that users receive today. Our understanding is that users do not view these amounts as revenue but rather as growth indicators that we believe should be contained in disclosures, as proposed.

Insurance contracts acquired in a business combination

We do not agree that an entity should recognize a loss on insurance contracts acquired in a business combination when the fair value of the insurance contracts' assets and liabilities is less than the measurement of those assets and liabilities in accordance with the proposed Update. We also do not believe that goodwill should be adjusted in such situations, as proposed in the IASB's revised Exposure Draft.

ASC 805 requires entities to measure the assets acquired and liabilities assumed at their acquisition-date fair value. We do not believe an exception to ASC 805 is warranted for the measurement of insurance contracts acquired in a business combination. Regardless of whether the insurance contract's assets or liabilities are recognized as one balance or separated into two components, we believe the total amount recorded upon acquisition should equal the fair value of the insurance contracts acquired.

Transition

The transition provisions would have a significant long-term effect on some insurance companies' results because existing contracts may stay in force for 20 or 30 years. Therefore, we believe the transition provisions need to result in the measurement of insurance contracts written before the transition date in a manner that will result in revenue, expense and profit recognition patterns consistent with insurance contracts issued after the transition date. We believe the Board's decision to apply the proposed Update retrospectively best achieves those objectives and that the practical expedients to determine the margin and the interest accretion rates adequately meet those objectives.

However, the proposal implies that companies could rely on information that may exist within the entity, but that information may not have been or cannot be subjected to auditing procedures. We believe that the practical expedient should be refined to limit the situations in which an entity would not be able to recognize a margin and would not have to use information that may be costly to accumulate and to audit.

Therefore, if full retrospective application is impractical, we believe the Board should consider simplifying the practical expedient to allow companies to use expectations as of the transition date. The total margin can be determined as the difference between the total premiums (charged or to be charged) for a portfolio of contracts and total estimates of expected cash outflows (paid or to be paid) and qualifying acquisition costs using historical data and assumptions at the transition date. That total margin could then be attributed across the life of the contract to determine the amounts that should have been earned and those yet to be earned which establishes the opening balance sheet margin. Although this mimics adjusting the margin for changes in expected cash flows, this approach should be considered, regardless of the Board's decision on adjusting the margin, as an approximate transitional method where full retrospective application is impractical. This approach uses consistent measurement principles for the opening balance sheet and, with disclosure, is preferable to the elimination of margins when objective historical evidence is not readily available.

Costs versus benefits

The proposed Update represents a comprehensive reconsideration of the accounting for insurance contracts that has evolved over many years as a result of emerging insurance products and features. This reconsideration would replace existing industry practices with principles that are consistent with other accounting standards. These principles would be applied consistently by both insurance and noninsurance entities. This reconsideration would be a significant change that would have a pervasive impact on the entities' core system applications, data needs, processes and controls. In addition, it would increase the amount of judgment in several areas of recognition and measurement. Entities would expend considerable energy educating internal and external users of their financial statements, given that much of the financial information reported would change along with most key performance indicators.

In its redeliberations, the Board should consider whether the benefits of changing the insurance accounting models sufficiently outweigh the costs that will be borne by entities. Areas that can be simplified such that more cost effective solutions can be applied should be considered.

* * * * *

We would be pleased to discuss our comments with the Board or the FASB staff at your convenience. Please contact Richard Lynch at +1 212 773 5601 or Jennifer Weiner at +1 212 773 9094.

Very truly yours,

Ernst + Young LLP

- Appendix A: Responses to specific questions raised in the Proposed Accounting Standards Update, *Insurance Contracts*

- Appendix B: EY's letter to the IASB's Exposure Draft, *Insurance Contracts*

Responses to specific questions raised in the Proposed Accounting Standards Update, *Insurance Contracts*

Scope

Question 1
Do you agree with the scope and the scope exclusions included in this proposed guidance, including its applicability to contracts written by noninsurance entities? If not, what types of contracts or transactions also should be included or excluded from the scope and why?

Response:

We agree with the principle that contracts that meet the definition of an insurance contract should be included in the scope of the proposed guidance rather than industry-specific guidance. This is consistent with other areas of accounting such as derivatives and leases for which the accounting guidance applies to all entities purchasing or issuing these instruments. However, we are concerned that without modifications to the proposed definition of insurance, the population of arrangements that would be required to use the guidance would be too broad.

We believe the Board needs to more clearly articulate the difference between a financial risk and insurance risk and clarify when compensation paid to another party fulfills an entity's own performance obligation. The Board decided to reduce the number of arrangements that would be required to follow the guidance through several scope exclusions. Those exclusions detract from the definition of insurance, are confusing, and would need to be updated as new products are developed and issues arise. The exclusions suggest the proposed definition is too broad. We believe that, if the Board narrows and clarifies the guidance on the types of contracts that would be in scope, the number of scope exceptions can be reduced.

While we agree with the objective that contracts with similar economic attributes, cash flows and risk transfer should be accounted for the same way, we do not believe the Board has adequately explored the various arrangements that would fall within the scope of the proposed guidance. We are particularly concerned about arrangements currently in the scope of ASC 460 on guarantees. The accounting for these arrangements should be addressed on a comprehensive basis if it is to be changed. Without a detailed analysis and a broader awareness by preparers that issue these types of arrangements, the resultant accounting may not adequately address these arrangements. In addition, the Board should consider whether the proposed guidance addresses the perceived issues that gave rise to the predecessor of ASC 460.

We would support a separate project that examines these types of arrangements, including the subsequent accounting that is not addressed in ASC 460. Notwithstanding our concerns, we do believe that some arrangements and components of arrangements issued by noninsurance entities are in substance providing insurance. Such a project would help clarify which arrangements would be considered insurance contracts and which would remain in ASC 460 or other accounting guidance.

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While the proposal indicates insurance must cover a pre-existing risk, this concept is not well understood outside the insurance industry. Accordingly, we believe further clarification is needed to avoid confusion. We recommend the Board specifically clarify when there is and isn't a pre-existing risk that would qualify for insurance contract accounting. For example, risk between two parties that is created by a transaction between those two parties would not be deemed insurance risk. Clarification of this fundamental aspect of insurance is necessary to distinguish insurance from routine transactions with customers. Such a clarification would prevent many common arrangements that noninsurers routinely enter into with their customers from being within the scope of the proposed Update.

In addition, we believe that entities should look at the substance of the transaction in its entirety which may result in some arrangements being accounted for based on the subsequent transaction. For example, an arrangement in which the settlement of a claim triggers a simultaneous, unavoidable transaction with the party that benefits from the loss event may not be insurance. We believe that a standby letter of credit in which a loan is created upon the settlement of the claim is more analogous to a loan commitment, which would be evaluated for impairment under the financial instruments guidance. Another example is an arrangement where the issuer of the guarantee (insurance) only compensates the contract holder if the contract holder enters into a secondary transaction. This type of transaction often requires the contract holder to exchange a current property it holds (trade-in) to purchase a new product to get a pre-determined value for the existing property. We do not believe the substance of these arrangements is insurance and therefore should not be in the scope of the proposed guidance.

Notwithstanding these comments, we recognize that there still will be a need for some explicit scope exclusions. Where possible, we believe the Board should focus on the characteristics of contracts rather than specific examples because many arrangements may share fundamental characteristics but only the ones that have been specifically scoped out would be excluded.

While the comments above address the broader aspects of the scope of the proposed Update, the following comments address the guidance as proposed.

We agree with the proposed guidance that the definition of an insurance contract should include the chance that the issuing entity will incur a significant loss. This is an improvement over existing guidance, which is vague for direct insurance contracts and requires a reasonable possibility of a significant loss for reinsurance ceded. We believe this will simplify the determination of whether the insurance contract guidance should apply.

We agree that contracts entered into with a single counterparty (or related counterparties) for the same risk or that are otherwise interdependent should be considered a single contract for purposes of the risk transfer analysis. However, we believe the Board should consider expanding this requirement to contracts for which the party that is ultimately responsible for the risk has direct involvement in determining the risk assumed by the intermediary. An example is a reverse mortgage written by banks with the collateral backstop provided by the US government. Another example is an insurer using an unrelated insurance company to obtain business in a state that the insurer is not licensed in (typically referred to as fronting arrangements). Under these arrangements, while the direct writer is legally the primary obligor to the contract holder, the essence of the arrangements is that the direct writer is acting as an agent for the entity that is ultimately assuming the risk.

We agree with carrying forward the criteria for when a financial guarantee is insurance and when it is not from ASC 815, *Derivatives*, which would now apply to all entities and not just insurance entities.

We also agree with specifying the characteristics for when a fixed-fee service contract would be excluded from the proposed guidance. We generally believe that the first two characteristics (i.e., pricing and compensation) are appropriate. However, the third characteristic relating to the risk arising primarily from utilization or frequency of the event is vague and may lead to the proposed guidance not being applied consistently across all entities. For example, third-party product warranty contracts are typically written as short-term contracts that can be renewed (extended). These contracts may start out providing only frequency risk (asset is relatively new) and turn in to severity risk as the probability of the underlying property failing (approaching the end of its useful life) increases. Therefore, the age of the underlying property could drive the determination of whether contracts are classified as insurance. Because the coverage is the same in each period, we do not believe the accounting should be different.

Notwithstanding these comments, we agree with explicitly excluding arrangements that are specifically addressed elsewhere in Codification. Similar to the exclusions of employee benefit plans (ASC 715) and retirement benefit obligations (ASC 960), we recommend that the Board also exclude health and welfare benefit plans as defined within ASC 965.

We also agree that the benefits an employer provides to its employees that otherwise meet the definition of an insurance contract should not be within the scope of the proposed standard.

While the examples of arrangements in the implementation guidance that would be within the scope of the proposed Update are helpful, they provide evidence that the proposed definition of insurance requires additional precision. Consequently, we believe the Board's interpretation of the arrangements that create an insurance contract needs to be clarified. For example, the descriptions section should clearly identify the event that causes the payment and the party that incurs the loss that the payment relates to.

We agree with the Board's decision to exclude from the scope of the proposal participating investment contracts issued by insurance entities that do not meet the definition of insurance. Scoping such contracts into the proposed Update would have run counter to the objective to create an insurance contract standard instead of a standard for the insurance industry. These contracts should be included in the scope of the proposal on accounting for financial instruments. We disagree with the IASB's decision in its revised Exposure Draft to scope these contracts into the proposed guidance.

Recognition

Question 2
Do you agree with the requirements included in this proposed Update for when noninsurance components of an insurance contract, including embedded derivatives, distinct investment components, and distinct performance obligations to provide goods or services, should be separately accounted for under other applicable Topics? If not, why?

Response:

We agree with the requirements in this proposed Update for when noninsurance components of an insurance contract, including embedded derivatives and distinct investment components, should be separately accounted for under other applicable Topics.

We also generally agree with the proposed guidance for when noninsurance components of an insurance contract relating to distinct performance obligations to provide goods and services should be separately accounted for under other applicable Topics.

However, there appears to be some confusion regarding when certain service obligations would need to be separated and accounted for under other Topics. Some believe that because the entity provides the administration services separately for some contracts, or other entities in the marketplace provide those services, these services would need to be separated and accounted for under other Topics for all contracts. We understand that that was not the Board's intent. We believe it would be helpful for the Board to clarify that the determination of whether a performance obligation is distinct should be made on a contract basis and the determination of whether a service is sold separately should also be made on a contract basis, taking into consideration how these particular contracts are sold in the marketplace, not how they compare with other contracts that provide similar services. This would clarify that the determination to separately account for a performance obligation for some contracts does not require the entity to separately account for that same performance obligation for all contracts issued. For example, an entity may perform third-party administration services that include policy maintenance and claims processing services and not provide any insurance. These services would be accounted for separately. Those same services are provided as part of an entity's activities that it must undertake to fulfill its obligation under insurance contracts where the entity has taken on the risks. In this case, these services would not be accounted for separately.

The Board should also clarify that fees for services related to a non-distinct investment component of a contract that is not separately accounted for should not be excluded from the proposed guidance and accounted for using other Topics. For example, revenue and expenses to manage the investments that are directly part of the insurer's obligation under the insurance contract should not be separated.

Other comments related to recognition

We agree with the proposed guidance that an insurance contract and a reinsurance asset or liability that covers aggregate losses of the portfolio of underlying insurance contracts should be recognized at the beginning of the coverage period. However, we believe the proposed guidance for direct proportional reinsurance by a ceding entity that requires a reinsurance asset or liability to be recognized when the ceding entity recognizes the underlying contracts should be expanded to assuming entities' initial recognition of insurance contracts they assume.

Measurement approaches

> **Question 5**
>
> **Do you agree that entities should apply different approaches to contracts with different characteristics, described as the building block approach and the premium allocation approach? If not, which model do you think should apply and do you think there should be any changes made to that model?**

Response:

Conceptually, insurance contracts should be recognized and measured using a single measurement model. However, we agree that simplifying the measurement model for some types of contracts would benefit issuing entities, and we recognize that this would result in two separate models. We believe the general principles underlying the two models should be consistent and that both models should have similar principles to other Topics.

We believe that the accounting differences between the premium allocation measurement model and the building block approach are warranted to portray the information of most importance to the users of the financial statements. For the most part, the premium allocation approach, once the coverage period ends, and the building block approach are converged. The recognition of the profit is not converged and we believe it should be treated the same under both models. See our response to Question 25.

We do not believe the accounting differences between the two models constitute different principles, except for the recognition of the profit. For example, not updating assumptions in the liability for remaining coverage under the premium allocation approach but recognizing an onerous contract if applicable, results in similar results to the building block approach if the margin is adjusted for changes in expected cash flows. In addition, we do not believe that the practical expedients (for example, not discounting the liability for remaining coverage if there is not significant financing, expensing qualifying acquisition costs if the coverage period is less than one year and not discounting the liability for incurred claims if the claim is expected to be paid within one year of the insured event) deviate from the general principle as these appear to be allowed due to the expected immateriality of the amounts.

If the general principles are modified to be consistent between the premium allocation approach and the building block approach, we do not believe that the premium allocation approach should be required for all contracts that meet the criteria to apply that approach. However, contracts that do not meet the criteria to apply the premium allocation approach should be required to use the building block approach. In our responses to the various questions, we have made suggestions to make these principles as consistent as possible. If the Board makes additional changes to the premium allocation approach, such that the principles between the two approaches vary significantly, we believe the application of the premium allocation approach should be a requirement when the specified criteria are met.

Question 6

Do you agree that entities should be required to apply the premium allocation approach if the coverage period of the insurance contract, considering the contract boundary guidance, is one year or less? If not, what would you recommend and why?

Response:

As noted in our response to Question 5, we do not believe that the premium allocation approach should be required and thus we do not believe that all contracts that are one year or less should be required to be accounted for using this approach. We do, however, believe the guidance should include a specific coverage period as a practical expedient for when the premium allocation approach can be applied.

Although "one-year" has generally been the cut-off for using practical expedients in other guidance, we believe the Board should consider extending the period to two years for use of the premium allocation approach without providing additional support to meet other criteria. We understand that entities sometimes write a contract that is identical to a one-year contract for a longer period of 15 months, for example. This sometimes occurs when contracts are written in an off-period such that the renewal date will be the same as other similar contracts and the contract holder doesn't want to have to re-underwrite and re-price the contract for a short period of time. In addition, claims made contracts that cover events reported during the coverage period typically include extended reporting periods, which essentially extends the coverage period beyond one year. We do not believe that entities should incur additional costs and complexities associated with the building block approach for a contract that is 15 months and a one-year contract when these are written simply for conventional business purposes. Extending the practical expedient to two years would capture these situations and we do not believe it would significantly increase the number of contracts that can use this criterion. However, we believe there are different considerations for contracts that provide coverage for greater than two years and therefore the other criteria should be applied.

In addition, if an entity writes predominantly longer term contracts and begins issuing one-year contracts, it would be required to apply the premium allocation approach for those contracts in addition to the building block approach for its longer term contracts. Also, because the proposed guidance would require entities to present insurance contracts liabilities/assets and the revenue and expenses from such contracts separately for contracts that are measured using the building block approach and the premium allocation approach, the financial statements could result in similar contracts being presented differently because of their duration. There would be minimal benefit to the entity and to the users of the financial statements, so permitting the use of the building block approach seems reasonable. We acknowledge that this could cause a lack of comparability between entities.

Question 7

Do you agree that entities should be required to apply the premium allocation approach if at contract inception, it is unlikely that during the period before a claim is incurred there will be significant variability in the expected value of the net cash flows required to fulfill the contract? If not, what do you recommend and why?

Response:

We believe that the characteristics of a contract should be the driving factor in determining which model should be applied. We agree with the proposed criteria, indicators and examples, but we believe the words are difficult to understand. Therefore, we believe the Board should clarify its intent. We believe the Board should clarify that the criteria should be considered on a contract basis. While there may be evidence that the expected losses on a portfolio level may vary over time, there typically isn't similar evidence for an individual contract (unit of measurement for this analysis). In addition, we believe the Board should clarify what is meant by significant variability in the expected value of the net cash flows. We believe the Board intended this to capture contracts where the expectation of an event occurring is the same throughout the coverage period and the assumptions at the contract level are not expected to vary before the event occurs. This is in contrast to contracts where there is an increasing likelihood of the event occurring or assumptions changing.

Portfolio and contract boundary

Question 8

Do you agree with definition of a portfolio of insurance contracts as included in this proposed guidance? If not, what do you recommend and why?

Response:

We do not agree with the proposed definition of a portfolio of insurance contracts. As described below, the proposed criteria could result in more portfolios than would be needed to meet the objective of the proposed Update. We understand there should be some level of consistency between reporting entities on how contracts are grouped for measurement to improve comparability. The proposed guidance should have a definition of portfolio that is sufficiently clear to achieve this objective of consistency.

We believe there should be one definition of portfolio that is used for all aspects of the proposed guidance; that is, entities should not change their groupings of contracts for different aspects of measurement of the liability or asset or for revenue and expense recognition. However, the proposed guidance references portfolio in a number of areas and implies that some of the measurement requirements would need to be performed at a more granular grouping of contracts than the criteria provided for determining a portfolio. For example, the Board's decision to require the interest accretion rates to be based on the discount rates when the portfolios of contracts are initially recognized could result in a new portfolio of contracts being established whenever there are changes in the discount rates. The Board should consider the interaction between the definition of a portfolio and other areas of the proposed guidance.

We agree with the principle that contracts with different risks should not be combined. However, it would be helpful if the Board would clarify that different risks within a single contract would not need to be separated. For example, different reserving methodologies are typically used when measuring the different risks within a contract, such as physical damage and bodily injury risks within an auto insurance policy or reserves for brain and spinal cord injuries within a worker's compensation contract. Because these risks are part of a single contract, we do not believe they should be in separate portfolios. In addition, the Board should consider whether risks can be combined when companies manage those risks together. This would be consistent with the accounting for an entire contract that contains different risks.

While we agree that portfolios should not contain products that are priced differently such that losses on a product would be delayed because profits on other products would offset those losses, we do not believe this principle should be applied to the pricing of risks within a product. For example, the price relative to the risk for life insurance that an entity can obtain for a 70 year old may differ from the price relative to the risk for a 40 year old, even though the type of risk may be the same. We do not believe the Board intended for portfolios to be created for each age group. In another example, pricing of a product may change over time (even within a year) based on market conditions. We do not believe the Board intended for portfolios to be created every time there is a change in pricing for a product.

We believe the second proposed criteria (contracts that have similar duration and similar expected patterns of release from risk) is too prescriptive. For example, a whole life contract sold to a 65 year old may be expected to have a duration of 25 years; the same contract sold to a 40 year old would be expected to have a 50-year duration. Under the proposed guidance, these contracts would need to be accounted for in separate portfolios. Therefore, requiring a contract's duration to be a primary factor in the portfolio determination could result in an entity having a burdensome number of portfolios. It also ignores the fact that insurance is written by combining risks. We agree with the principle that a different pattern of revenue recognition should not result from combining two or more contracts. This is consistent with the Board's proposed revenue recognition guidance on a series of two or more distinct goods or services satisfied over time. However, we believe the proposal to recognize the margin as the entity is released from risk takes into consideration the varying durations of contracts in a portfolio. Therefore, to meet the Board's principle, these contracts do not need to be separated into different portfolios. For clarity, the Board could consider stating that principle.

In defining a portfolio, we believe there should be clear evidence that links a group of contracts. A strong indicator that contracts are similar and should be part of a portfolio is that they are managed together. If the Board considers this criterion to define a portfolio of contracts, as is proposed in the IASB's revised Exposure Draft, the Board should specify the level at which this criterion should be applied. The criteria included in the guidance for segment reporting may be a good starting point, given the other criterion would apply within the segment. However, the segment reporting criteria is for reporting purposes. The criterion for portfolios is used for measurement purposes and, therefore, may need to be at a lower level.

If the determination of portfolios is changed to consider the way contracts are managed, other complexities must also be considered. Some entities may change the way the business is managed and thus may change their portfolios to reflect that change. The Board should consider adding guidance for determining the amount of margin that would transfer with contracts that change portfolios as a result of changes in the way these contracts are managed, consistent with the guidance for re-allocating goodwill. And, if interest accretion rates remain locked in, as required in the proposed Update, (see our response on Question 16) making changes to groupings of portfolios could be even more complicated.

Question 9

Do you agree with the requirements included in this proposed Update on contract boundary (that is, the requirements that establish how to identify the future cash flows that will arise as the insurer fulfills its obligations)? If not, what do you recommend and why?

Response:

We agree with the proposed guidance for the contract boundary for an individual contract. We also agree that for some types of contracts, the contract boundary should be considered at the portfolio level rather than the individual contract level. We agree that when the entity has the right or practical ability to reassess the risk of the portfolio that contains the contract and, as a result, can set a price or level of benefits that reflects the risk of that portfolio, the contract boundary should end. We believe the second criteria regarding the pricing of contracts taking into account risks relating to future periods is already in the first criteria and therefore is not needed.

Reinsurance contracts for long-duration contracts are sometimes written based on a "yearly renewable term" in which the reinsurance arrangement covers contracts written during a given year but can be canceled or re-priced (typically up to some cap) each year for the continuation of the coverage for those contracts. Ceding companies will account for these arrangements using the same model applied to the underlying contracts included in the arrangement, which most likely would be the building block approach. From an assuming company point of view these contracts could be viewed as contracts with a one year contract boundary, because of the re-pricing feature and how the cap is considered. However, the contract provides coverage on a long-term basis, the expected cash flows in the underlying contracts include multiple years and there could be significant variability in the cash flows prior to the claim being incurred. Therefore, including expected cash flows beyond one year may make more sense. We recommend the Board include guidance based on the implementation guidance for determining significant insurance risk that permits unlikely scenarios to be considered in the determination of whether the assuming company has the ability to re-price for the risks in the reinsurance contract.

Fulfillment cash flows

Question 10

Do you agree with the types of cash flows that would be included in the measurement of the fulfillment cash flows, including embedded options and guarantees related to the insurance coverage under the existing insurance contract that are not separated and accounted for as embedded derivatives? If not, what cash flows do you think also should be included or excluded and why?

Response:

We agree that the cash flows that should be included in the measurement of the contract should include amounts specifically chargeable to the contract holder and all costs directly attributable to fulfillment of contracts or contract activity as part of fulfilling a portfolio of contracts that can be allocated to those portfolios. Taking into account these expected cash flows of an insurance contract will best reflect the direct economic relationship between the insurer and contract holder.

We also recognize that all entities have to incur some level of expenses to operate and that the pricing of products or services includes an amount to cover those costs. However, we do not believe that such costs should be included in the measurement of the insurance contract's liability or asset. Therefore, we agree that cash flows that result from the insurance contract being written but that are not part of the contract between the insurer and the contract holder (e.g., insurance-related assessments, transaction-based taxes) should be excluded. The accounting for such costs by insurers should be the same as the accounting applied by other entities for similar expenses.

We believe that the list of types of cash flows that should be included in and excluded from the measurement of the liability in paragraphs 834-10-55-79 through 55-80 in the implementation guidance is helpful. We note that the IASB, in its 2013 re-exposure draft, explicitly included transaction-based taxes (e.g., premium taxes, value added taxes, goods and services taxes) and levies (e.g., fire service levies, guarantee fund assessments). The Board, in our view appropriately excluded these costs in its list in the aforementioned paragraphs. However, the IASB also included fixed and variable overhead costs such as for accounting, human resources, building depreciation, rent and utilities in the cash flows. We do not believe it was the Board's intent to include such costs, nor do we believe such costs should be included. For clarity, we recommend that the Board explicitly state that these costs should not be included in the measurement of the cash flows of the insurance contract liability.

We also recommend the Board consider whether certain information technology costs should be included in the cash flows, specifically, automated functions that, if performed by a person, would be included.

The proposal does not address whether funds withheld balances should be included in the expected cash flows. It is common in reinsurance transactions for the ceding entity to maintain an account for the reinsurance activity, such as premiums due to the reinsurer and recoverables from the reinsurer on losses paid, rather than exchanging cash. This is generally referred to as a funds withheld arrangement. The account typically is credited with interest, is sometimes settled throughout the term of the arrangement, and at the end of the term of the reinsurance arrangement any remaining balance is transferred to the reinsurer. We do not believe the Board intended to include funds withheld balances in the expected cash flows given that this is an alternative form of cash settlement, but the proposed guidance is not clear. If the Board intended for funds withheld balances to be included in the expected cash flows, the guidance should clarify that this amount would be considered a component that is contractually linked to the account balance and therefore should be measured at the account balance. Because it would be included in the insurance contract liability, entities should disclose these balances.

The proposed Update does not address situations in which the expected amount of premium is dependent on contract holder behavior and cannot be estimated reliably. For example, some contracts allow contract holders to pay an additional amount (dump in premiums) to purchase expanded coverage. These amounts are non-contractual and typically uncertain (i.e., they cannot be reliably estimated based on historical experience). In these cases, we do not believe an entity should include these future premiums in the expected cash flows. Instead, when these additional premiums are received, an entity should adjust its expected cash flows and the margin (see our response to Question 13). This is consistent with paragraph BC209 where the Board clarified that an entity should not consider expected changes in coverage in the measurement of the liability for remaining coverage. This is also analogous to the Board's proposal on revenue recognition. In that proposal, if a customer has the option to acquire an additional good or service at a price that would reflect the standalone selling price for that good or service, that option does not provide the customer with a material right even if the option can be exercised only because of entering into a previous contract. In those cases, the entity has merely made a marketing offer that it should account for only when the customer exercises the option to purchase the additional goods or services.

Question 11

Do you agree that the assumptions used in the measurement of the fulfillment cash flows should be updated each reporting period? If not, what do you recommend and why?

Response:

We agree that the assumptions used in the measurement of the fulfillment cash flows should be updated each reporting period.

Question 12

Do you agree that the fulfillment cash flows for contracts measured using the building block approach and the liability for incurred claims for contracts measured using the premium allocation approach should be based on explicit, unbiased, and probability-weighted estimates (that is, the mean) of the future cash flows, as of the reporting date, expected to arise as the entity fulfills the contract, adjusted to reflect any contractual linkage between the contract and any underlying assets? If not, what do you recommend and why?

Response:

We agree with the Board that one component of an insurance liability should be the probability-weighted mean estimate of future cash flows. However, we recognize that in any calculation the views of management will influence the selection of expected cash flows and the related probability of those cash flows. We believe that the use of the term "unbiased" is intended to prevent unduly optimistic or pessimistic assumptions (i.e., the assumptions should be neutral). We recommend that the Board remove the notion of "unbiased" from the proposed guidance and provide robust guidance on the objective of the calculation of the present value of probability-weighted cash flows.

We also agree that the expected cash flows should be a probability-weighted mean. However, to meet the Board's objective, we do not believe that all assumptions included in the modeling need to be probability-weighted; rather the outcomes used need to be probability-weighted. Therefore, we believe the Board's objective would be met when the estimates used produce a mean of expected cash flows. Without this clarification some entities might interpret the guidance as requiring a significant amount of additional work.

We agree that the measurement of the insurance contract liability (or asset) should reflect the insurer's obligation to the contract holder and therefore the measurement of the insurance contract liability (or asset) should consider in the cash flows any contractual linkage to an underlying item. See our response to Question 35.

In March 2013, the Board released a Frequently Asked Questions document on the proposed Accounting Standards Update, *Financial Instruments – Credit Losses (Subtopic 825-15).* In Question 10 of that document, the Board stated: "The estimate of expected credit losses should consider current conditions and reasonable and supportable forecasts about the future. As a starting point, however, the Board expects that an entity's estimate of expected credit losses largely will be informed by historical loss information for financial assets of a similar type and credit risk. Once an entity has developed or obtained that historical loss information, the entity will need to evaluate whether and how the historical loss patterns differ from what is currently expected (which would be based on current conditions and reasonable and supportable forecasts). To do so, the Board expects that an entity would consider (a) the economic conditions that existed for the period over which historical statistics were developed and (b) how those conditions differ from what management currently expects will be the economic conditions facing the entity." Similar factors exist in the estimation of the expected cash flows for insurance contracts. This is most significant for mortgage and financial guarantee insurers where the assumptions that have the most significant effect on the expected losses is related to macro-economic conditions such as financial market and home appreciation rates and unemployment. We recommend the Board include similar guidance regarding the use of historical loss patterns updated for current conditions and reasonable and supportable forecasts in determining the expected value for the measurement of the fulfillment cash flows. This would provide consistency in measurement between the proposed Update and the financial instruments guidance.

Other comments related to measurement of the fulfillment cash flows

We agree that for contracts measured using the premium allocation approach an onerous contract test should be performed when facts and circumstances indicate that a portfolio of contracts may be in a loss position. We also agree that there should not be an exception for certain types of contracts such as contracts that cover losses from hurricanes. However, we believe that a liability that is based on an expectation of future events (e.g., an onerous liability) should not be measured solely using information that is available on the financial statement date. We believe it is appropriate to use information after the balance sheet date when the liability is measured based on expectations of future events. Accordingly we do not support the Board's proposal to limit the information used to measure an onerous contract to expected loss information that would be known as of the balance sheet date. For example, if at 30 September a hurricane is expected to make landfall on 2 October and the entity determines at 30 September that a portfolio of contracts is expected to be onerous, the measurement of the estimate of the onerous contracts should be updated with current information. We do not believe ASC 855 on subsequent events is relevant for measurement of events yet to occur. In addition, we do not believe the costs to estimate the expected cash flows based on preliminary information that may no longer be relevant versus current information that may be more relevant outweighs the benefits to financial statement users. We are also concerned that, under the proposed guidance, an entity would need to perform procedures to determine its estimate for expected losses using data as of the reporting period date for recognition in its face financial statements and its estimate based on the actual occurrence, for disclosure purposes (Type II subsequent event) and on an ongoing basis to determine its losses. This would be complex and costly.

Question 13

Do you agree with the approach in this proposed Update to recognize changes in estimates of cash flows (other than the effect of changes in the liability arising from changes in the discount rate) in net income in the period? If not, what do you recommend and why?

Response:

We agree that differences between expected cash flows and actual experience should be recognized in net income in the current period.

However, we believe that, similar to the day one measurement, the margin should reflect the "remaining unearned profit" expected from the future cash flows and services between the insurer and contract holder/beneficiary at each reporting date. In other words, the margin should reflect the remaining unearned profits that flow from the expected consideration and the outflows to fulfil the obligations under the portfolio of contracts. Consequently, we do not agree that changes in estimated cash flows should be recognized in net income.

Instead, both favorable and unfavorable changes in expected cash flows (other than the effect of changes in the discount rates) such as, mortality, longevity and general insurance claims should be recognized as adjustments to the margin, up to the amount of consideration expected to be received. The margin should not be below zero and therefore any excess adjustments would be recognized as a loss. However, the margin should not reflect profits the insurer expects to earn through sources that are not part of the measurement of the insurance contracts (e.g., an interest rate spread between earnings on investments and accretion of interest on the insurance contract portfolios).

Because changes in future cash flows can be caused by several items, some of which may be related to current actual experience and others will be related to future events, if the Board decides to adjust the margin the Update would need to provide guidance to distinguish current-period and future-period cash flows. The following are a few examples of cash flow changes that will need to be evaluated.

- A contract lapses and future expected premiums anticipated from the contract will not occur.

- A contract that was expected to lapse in the current period is now expected to lapse in five years, so there will be an additional five years of premiums paid.

- There are fewer deaths in the current period, which results in an expectation that the number of deaths in the future will increase.

We believe that changes in expected future cash flows caused by current-period events should be recognized in net income as current-period experience rather than adjustments to the margin. However, if the current-period event results in a change in benefits, the margin should be adjusted.

Without sufficient guidance for these items, we believe that diversity in practice on the application of unlocking the margin for changes in expected cash flows could emerge, resulting in a lack of comparability of reported profit emergence among insurers.

If the Board decides to adjust the margin for changes in expected cash flows, the guidance will need to address how to recognize favorable changes in future cash flows when the entity previously recognized losses in net income because the adjustment to the margin was limited (i.e, margin cannot be negative). We think that insurers should first reverse any previously recognized losses in net income before re-instating the margin. This would prevent the total margin that is earned from exceeding the actual margin.

Because the acquisition costs are essentially recouped by the margin, the Board would need to consider whether the amount of expected or incurred acquisition costs not yet recognized in net income should be the floor for the margin, at which point losses would be recognized for any additional unfavorable changes in expected cash flows. The Board also would need to consider the implications on the recognition of expense for acquisition costs. We do not believe that previously expensed acquisition costs should be reversed. Therefore, the Board may need to rethink whether recognizing acquisition costs in the same pattern as the margin will continue to be operable.

If the Board decides to adjust the margin for changes in expected cash flows, it would also need to decide how the adjusted margin should be calculated. A retrospective catch-up approach may be most theoretically sound. This would partially mitigate the Board's concern that the margin would "act as a "buffer" for potentially smoothing either favorable results or unfavorable results." It would also alleviate the complexities of differentiating between actual experience adjustments and changes in future expectations if the margin is adjusted on a prospective basis and would not skew future results based on when the adjustment was made. While a retrospective catch-up approach may be most theoretically correct, the complexities of adjusting the margin retrospectively may outweigh the benefits and a prospective approach may be a practical solution.

The proposed Update implies a portfolio should be closed versus open. An open portfolio combines previous-period contracts with current-period contracts. This allows expected profits from current-period contracts to offset losses that might arise from prior-year contracts. This becomes more important when adjusting the margin; our preference would be for the margin to be determined on a closed portfolio. However, if the Board believes an open portfolio is acceptable, the guidance should be clarified and additional guidance will be needed to explain how an open portfolio should be applied in relation to the Board's definition of a portfolio.

Notwithstanding our comments above, if the Board decides that the margin determined at initial recognition should be retained for the estimation risks in the portfolio or that adjusting the margin for changes in expected cash flows adds unnecessary complexity and detracts from transparency, we would not object to recognizing changes in expected cash flows in net income. However, we believe entities shouldn't recognize changes in the expected cash inflows in net income as proposed. Instead, we believe that the expected profit related to changes in expected cash inflows that relates to extending or obtaining increased coverage, should adjust the margin because every dollar of premium has a profit associated with it. The reasons for deferring expected gains on the initial expected cash flows equally applies to any additional expected cash inflows; that is, an entity has not yet performed under the contract and there is uncertainty in the insurance contract about whether the gain will occur. Therefore, if the expected premium increases, or decreases, the margin should be adjusted. This would be consistent with the proposed guidance for non-substantial modifications in the proposed Update. Absent such an adjustment, entities could recognize revenue merely by adjusting their assumptions.

Discount rates and discounting

Question 14

Do you agree that the discount rates used by the entity for nonparticipating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?

Response:

The selection of discount rates would have a significant impact on the accounting for insurance contracts. The discount rates need to achieve a balance between providing a measurement model that fairly represents the economic relationship between the insurer and the contract holder and at the same time produces a liability that reflects the current expected value to fulfill the insurer's obligations. The discount rates utilized and the interest accretion rates also must provide meaningful performance measures and be consistent with the economics of the business.

We understand and agree with the Board's desire to use a discount rate that is based on the characteristics of the liability, rather than the assets used to fund that liability, to provide a more consistent measurement among entities. However, we are concerned that using the characteristics of the liability as the basis could result in diversity in practice. Not everyone has the same view of how to determine the characteristics of the liability, and the pricing of the contracts may reflect economics that could not align to the characteristics. Specifically, a contract could not transfer any market risks (i.e., risk free) to the contract holder, but it may have been priced with implied interest rates that are above the risk free rate. We would point out that in its projects on leases and revenue recognition the Board considered the pricing of the arrangements that includes an explicit or implicit interest (or financing) component in determining the discount rates. We believe, to be consistent, the Board should consider whether the pricing of an insurance contract should be a factor in determining the discount rates for the insurer's obligation.

We also have concerns with the two approaches proposed in the implementation guidance.

- We agree with using a yield curve that reflects current market rates of returns either for a reference portfolio of assets or the actual portfolio of assets the entity holds adjusted to exclude factors that are not relevant to the insurance contract liability. But the lack of clarity in the approach could lead to diversity in practice and lead to lack of comparability. Specifically, we believe that when using an actual portfolio of assets as the starting point in determining the discount rates, the Board should consider allowing all assets held that are designated as backing the portfolio of insurance contracts, to be considered. Insurers, and more frequently life insurers, invest in various types of investments, some of which are non-fixed income investments, to implicitly hedge their risks to market movements. This reflects asset-liability management such that the overall yield on the asset portfolio can be considered to reflect the characteristics of the liability and for which these insurers should not be penalized by not including yields on these investments in the determination of the discount rates.

- We also are concerned that there will be diversity in practice in determining the liquidity adjustment when added to the risk-free rate. We do not believe the proposed Update adequately articulates the underlying rationale and objective of a liquidity adjustment. This lack of clear rationale and objective, likely will result in inconsistent application by insurers and difficulty in auditing such an adjustment. Where a liquidity adjustment is required, such as in Solvency II, prescriptive calculations are provided that may be appropriate for regulatory purposes, but we do not believe is appropriate for general purpose financial statements. Therefore, we believe the Board should establish a clear principle explaining how a liquidity adjustment should be calculated. However, even if a principle is developed, we have concerns that the complexities to determine this adjustment each period may outweigh the benefits of discounting at a rate that may more closely reflect the characteristics of the liabilities.

We expect that most entities that would need to apply the premium allocation approach will have insurance liabilities whose characteristics generally will not include any risk associated with assets, so starting with a risk-free rate and adding a liquidity adjustment may be preferred. Therefore, if the Board decides to not permit a risk-free rate plus a liquidity adjustment due to uncertainties in determining the liquidity adjustment, we believe it will be necessary to have an alternative method to an approach that starts with the yield on a reference or actual portfolio of assets. We believe the risk-free rate would be an appropriate alternative.

While we understand the conceptual basis of developing a discount rate that attempts to reflect a rate that is consistent with the characteristics of the contract, the proposed approaches in the implementation guidance are complicated, require significant judgments about components of a yield curve (some of which may not have observable market information) and will not reflect how the pricing of the arrangement was determined. Similar to existing GAAP, neither approach included in the implementation guidance would lead to the same discount rates being applied by different entities. However, we believe the proposed requirement to disclose the yield curves and the related expected cash flows would improve transparency and provide useful information to users of the financial statements. Because of this transparency and the complexity and lack of consistency in the two approaches proposed, we believe the Board should consider allowing practical expedients.

If the Board decides a risk-free rate plus a liquidity adjustment is appropriate, the Board should consider allowing entities, especially those applying the premium allocation approach, the option to use the risk-free rate for discounting its non-linked liabilities. We believe this option should be irrevocable and should be used for all portfolios of contracts accounted for using either the premium allocation approach or the building block approach. This would minimize the complexity and the costs to comply.

The Board should also consider allowing entities to discount non-linked liabilities using a high-quality corporate bond rate similar to ASC 715, *Compensation — Retirement Benefits* or a risk-free rate similar to the guidance in ASC 820, *Fair Value Measurement*. This would minimize the complexity and the costs to comply. Consistent with the option to use the risk-free rates, we believe this option should be irrevocable and should be used for all portfolios of contracts accounted for using either the premium allocation approach or the building block approach.

We believe the Board needs to address the discount rates that should be applied to fee provisions that are based on asset values. The fees (premiums) for some insurance contracts are based on a percentage of a contract holders account balance. Because these cash flows are included in the fulfillment cash flows of the contract, discounting them at the appropriate rate is critical to avoid non-economic volatility. The Board should consider requiring entities to discount the fees at the same rates as the expected asset accretion rates.

Many insurance contracts have expected durations that extend beyond the period of observable market yields. Discounting cash flows expected in periods for which there are no observable data points may significantly affect the current period value of the insurance contracts and may have similarly significant effects on an insurer's financial statements. As a result, the guidance on how to determine the discount rate for that portion of the cash flows is a critical aspect of the proposal. The guidance included in paragraph 834-10-55-96 is unclear with respect to how insurers should estimate the discount rates for those periods. That guidance first states that an estimation technique could be used, but then also indicates those rates could be determined using the current, observable market yield curve for shorter durations. To clarify what we believe was the Board's intent, the Board should consider incorporating into paragraph 834-10-55-96 the language in paragraph BC151 that states "because forecasts of unobservable inputs tend to put more weight on longer term estimates than on short-term fluctuations that [estimation techniques] would counteract concerns that current period fluctuations in discount rates exaggerate the volatility of the very long-term liabilities."

As we have previously noted, potential financial statement volatility that is created by the application of the proposed standard is a significant concern for insurers. Very recent field testing by several North American insurers has highlighted these issues and that a significant contributing factor to that volatility is the use of observable points along a market yield curve that may be viewed as not being represented by a deep and liquid market when determining the discount rate. Before the Board proceeds to a final standard, we recommend it carefully consider the results of this useful field testing, as well as the results of any other field testing that is or has been performed by insurers in other geographic areas. That consideration should include evaluating the results with industry representatives and with users of insurers' financial statements to determine whether the application of the proposed standard produces financial results that are consistent with the Board's overall objective and produces decision-useful information for users of such financial statements.

Question 15

For contracts measured using the premium allocation approach, do you agree that an entity should discount the liability for incurred claims? Do you agree that entities should be allowed to elect not to discount portfolios when the incurred claims are expected to be paid within one year of the insured event? Why or why not? If not, what would recommend and why?

Response:

We agree that the insurance liability should reflect the time value of money. Therefore, we agree that an entity applying the premium allocation approach should discount the liability for incurred claims. Also, we agree with the practical expedient to not apply discounting when the claims are expected to be paid within one year of the insured event because the costs to apply discounting would not outweigh the beneficial information provided to users of the financial statements.

However, the guidance implies that the practical expedient must be applied to a portfolio in its entirety. We believe the practical expedient should be applied to individual claims. The Board should consider modifying the practical expedient to allow insurers to not discount any claims that are paid within one year of the insured event.

Question 16

Do you agree that an entity should segregate the effects of underwriting performance from the effects of changes in discount rates (which would reverse over time) by recognizing changes in the present value of the fulfillment cash flows due to changes in the discount rates in other comprehensive income? If not, do you think that the effect of changes in the discount rates should be presented in net income? Please explain your reasoning.

Response:

A key concern that was raised in the 2010 Discussion Paper (DP) and continues to exist in this proposal is volatility in both the income statement and the equity as a result of changes in interest rates. We agree with the Board's decision to recognize the effect of changes in the discount rates in other comprehensive income (OCI) to mitigate the volatility in the income statement resulting from updating the assumptions of the discount rates each reporting period, even though this approach increases the complexity of the guidance. We understand that the Board's intent is to isolate the changes in underwriting from the changes in the discount rates and to minimize accounting mismatches while recognizing economic mismatches. However, we are concerned that requiring the effects of changes in discount rates to be recognized in OCI for all non-contractually linked contracts may exacerbate the accounting mismatches.

Although we agree that the effect of changes in the present value of the fulfillment cash flows due to changes in the discount rates should be recognized in OCI, we do not agree that it should be required for all non-contractually linked liabilities. A significant portion of an insurer's investment portfolio includes fixed income assets and asset-backed investments, much of which are accounted for at fair value through OCI under existing GAAP. However, many of these assets may be required to be accounted for at fair value through net income under the Board's proposed guidance on financial instruments. Insurers also invest in equities, derivatives and limited partnerships that are accounted for at fair value through net income and real estate and mortgage loans that are accounted for at amortized cost, among other investments. The investment decisions typically depend on the characteristics of the liabilities within a portfolio, most importantly the duration of the liabilities and how interest rate movements affect them. While we believe that the accounting for insurance liabilities should not be based on the types of assets that a particular insurer holds, we also emphasize consistent measurement and presentation of changes in value for certain aspects of both the insurance liabilities and all invested assets is necessary to minimize accounting mismatches. We concur with the Board that standards generally should not give entities the option to choose their accounting. However, when there is a clear rationale such as minimizing accounting mismatches, we believe policy choices can be acceptable as long as the choice is disclosed.

We believe, where possible, entities should be provided accounting options to avoid accounting mismatches. Therefore, we believe entities should have an irrevocable choice at the portfolio level to determine whether to recognize changes in discount rates in either OCI or net income. Requiring the choice to be made at the portfolio level will not eliminate all accounting mismatches but will mitigate some of the volatility in earnings resulting from those mismatches. Providing such an option would not promote comparability between insurers. But requiring the disclosure of how discount rate changes in insurance liabilities are reported would provide users with sufficient information to understand the lack of full comparability. We believe this approach would provide users with better information than they currently receive and will align, to the extent possible, the financial reporting of companies with their asset/liabilities management strategies. This alignment also would increase transparency by allowing users to understand how the business is managed.

Question 17

Because this proposed guidance includes the approach that changes in the insurance liability arising from changes in the discount rates should be recorded in other comprehensive income, do you think that a test should be required to trigger recognition in net income of some or all of the amounts in accumulated other comprehensive income (that is, a loss recognition test based on asset-liability mismatches)? Why or why not?

Response:

We believe that the proposed guidance should include a loss recognition test. Specifically, entities should reverse interest rate changes that reduced the insurance liabilities from other comprehensive income into net income when the entity determines that it is highly probable the premiums charged and the expected investment income on the assets purchased or likely to be purchased with the premiums will be insufficient to cover the claims.

Using other comprehensive income for the effect of changes in the discount rates is intended to address the belief that short-term fluctuations in the discount rates are less relevant to understanding the long-term performance of the insurer, the changes will reverse over time, and including the changes in current net income could distort the insurer's current performance. However, once the interest rates fall to a level that all market indicators project that the interest rates are expected to be substantially below the discount rates determined at inception, the financial statements should reflect that the entity will be unable to fulfill its obligations without utilizing the equity of the entity. Those fluctuations will not likely reverse, which is one of the reasons used to permit the use of OCI. Reversing the amounts recorded in OCI when the entity determines that it is highly probable the premiums charged and the expected investment income on the assets purchased or likely to be purchased with the premiums will be insufficient to cover the claims is consistent with impairment charges recognized on financial instruments and other assets.

Also, without such a test, the transparency of the quality of an entity's earnings will be compromised. That is because losses on a specified portfolio of insurance contracts could be obscured by the returns of the entity's profits emerging from other portfolios of insurance contracts (e.g., assets backing profitable portfolios will be used to pay liabilities on loss portfolios).

Question 18

Do you agree that the method for calculating the discount rates should not be prescribed? Is the proposed guidance on determining the discount rates understandable and operable? If not, what do you recommend?

Response:
We agree that the calculation of the discount rates should be based on a principle and not on prescribed guidance.

The proposed guidance is understandable, but we have concerns that guidance limits the types of assets that can be used when starting with an entity's actual investment portfolio. See our response to Question 14.

Question 19

Do you agree that interest expense generally should be based on the discount rates determined at the date the portfolio of contracts was initially recognized? Why or why not? If not, what do you recommend?

Response:
We agree that interest expense should be based on a locked-in accretion rate, even though doing so would make the accounting more complex. We believe this approach is necessary because of the Board's decision to recognize the effect of current period changes in the discount rates used to value the insurance portfolios in OCI. However, the definition of portfolio is not specific as it relates to the accretion rate. We are uncertain whether the Board intended that entities would need to have closed portfolios to apply the interest accretion guidance. Although this is not stated in the proposal, accreting interest at the initial recognition discount rates as proposed in the guidance appears to require entities to create a set of portfolios each time their discount rates change. We do not believe the Board intended to force entities to have multiple portfolios for the same product within a given reporting period. Requiring multiple portfolios for the same product would mean entities would need to capture an enormous amount of data to calculate the difference between the current rates and the multiple locked-in rates for each portfolio each reporting period.

Therefore, we propose that when a closed portfolio is used, the Board consider allowing entities to use an average interest accretion rate. This practical solution would minimize the complexity and the cost of compliance.

If the Board rejects the notion of an average locked-in interest accretion rate, then we believe interest expense should be based on the discount rates determined at the date the portfolio of contracts was initially recognized. The discount rates at initial recognition are most consistent with the rates considered when pricing the insurance contracts and are consistent with other areas of accounting, such as leases and financial instruments.

However, for contracts accounted for under the premium allocation approach the Board should consider whether the locked-in interest accretion rate at the beginning of the accident period used to project the losses could be a policy election. Under this approach, entities would not be required to change their reserving process from an accident-basis (for example, quarterly or yearly), which is most common in the US, to an underwriting-basis. This would minimize the complexity and the cost of compliance.

If the Board does not allow the locked-in interest accretion rates to be based on an accident-basis, the Board should consider a practical expedient for outstanding claims at the date of transition for which underwriting year data was not previously captured. Determining the discount rates at initial recognition for the contracts in force at transition would be extremely cumbersome.

Question 20

Do you agree that upon any change in expectations of the crediting rates used to measure the insurance contracts liability for insurance contracts with discretionary participation features, the interest accretion rates should be reset in a manner that recognizes any changes in estimated interest crediting and related expected cash flows on a level-yield basis over the remaining life of the contracts? If not, what do you recommend?

Response:

We agree that upon any change in expectations of the crediting rates used to measure the insurance contracts liability for insurance contracts with discretionary participation features, the interest accretion rates should be reset. However, the proposed guidance should clarify that all changes in future expected crediting rates should be considered in determining the entity's' expected cash flows. Instead of using an approach that solves to a level-yield for the remaining life of the portfolio of contracts, the initial yield curves should be updated such that it reflects the timing of the expected crediting and the timing of cash flows.

Margin for contracts measured using the building block approach

> Question 21
>
> **Do you agree that an insurer should not recognize a gain at initial recognition of an insurance contract (such a gain would arise when the expected present value of the cash outflows is less than the expected present value of the cash inflows) but, rather, should defer this amount as profit to be recognized in the future? Why or why not?**

Response:

We agree that, at initial recognition of an insurance contract or reinsurance contract, a gain should not be recognized as an entity has not yet performed under the contract and there is uncertainty about whether the gain will occur. However, if the Board decides in either the revenue recognition or the financial instruments projects that gains at inception are allowed for unobservable rights, the Board should reconsider whether gains should also be permitted for insurance and reinsurance contracts.

> Question 22
>
> **Do you support using a one-margin approach, as is included in this proposed guidance, or an explicit risk adjustment and a contractual service margin (as the IASB proposes)? Please explain the reason(s) for your view.**

Response:

We would not object to using the one-margin approach included in the proposed guidance with modification on the period amortized. However, we also would not object to a two-margin model under which an entity would recognize a provision for uncertainty and a residual margin.

We recognize that the proposed margin represents the amount of expected consideration (premium) in excess of the expected cash outflows and is intended to compensate the entity for several items including accepting risk that actual benefits are greater than expected, general operating costs to run a business, and an economic return to the entity's shareholders. The entire excess amount or expected profit is at risk due to the uncertainty in the cash flows. Decomposing the excess amount into separate measurement amounts may provide relevant information if the underlying principles that require the separate measurement is sufficiently clear and will result in comparability across entities. However, the costs to prepare and update these amounts may not justify a model that has more than one margin.

We do not believe there is a conceptual reason for there to be a difference in regards to when expected profit is recognized in net income between the building block approach and the premium allocation approach. Therefore, either the margin should be recognized over the coverage and settlement period as proposed for the building block approach or the margin should be decomposed into two components, a residual margin that would be recognized over the coverage period and a provision for uncertainty that would be recognized over the coverage and settlement period as the uncertainty in the cash flows decreases. For the premium allocation approach, either the liability for remaining coverage should be earned over the coverage and settlement periods or a provision for uncertainty should be recognized when a claim is incurred.

As previously noted, we also would not object to the guidance having an explicit provision for uncertainty and a residual margin if the provision for uncertainty provided useful information. But, we are concerned that the provision for uncertainty could become a standardized add-on to the mean or a way for management to inject bias into the measurement process. Further, we continue to be concerned, as noted in our 2010 letter, about the reliability of estimating a provision for uncertainty. Therefore, we believe the objective of the provision for uncertainty needs to be clearly defined, the provision for uncertainty and diversification benefits for claims yet to be incurred should be required to be calculated at a portfolio level and specific disclosures should be required around the techniques used and assumptions made when calculating the provision for uncertainty.

Question 23

If you support a risk adjustment and a contractual service margin, do you agree with the IASB's approach to adjust the contractual service margin for changes in estimates of cash flows? Why or why not? Do you agree with the IASB's approach to not specify acceptable approaches to determining the risk adjustment? Why or why not?

Response:

See our responses to Questions 13 and 22.

Question 24

Do you agree that a loss at initial recognition of a portfolio of insurance contracts should be recognized immediately in net income (such a loss would arise when the expected present value of the future cash outflows exceeds the expected present value of future cash inflows)? Why or why not?

Response:

We do not believe the margin should be less than zero. Therefore, we agree that a loss at initial recognition of a portfolio of insurance contracts should be recognized immediately in net income. Should the Board decide to adjust the margin for changes in expected cash flows, any adjustments beyond the remaining margin should also be recognized immediately in net income. See our response to Question 13.

Question 25

Do you agree with the proposed method(s) of recognizing the margin (that is, as the entity is released from risk under the insurance contracts as evidenced by a reduction in the variability of cash outflows)? If not, what do you suggest and why?

Response:

We believe that releasing the margin as the entity is released from risk under the insurance contract, as evidenced by a reduction in the variability of cash outflows, is an appropriate principle because this would be consistent with the notion that the profit is more certain at that point in time. However, we also acknowledge that entities have to complete many tasks over the life of an insurance contract and have to expend resources (costs) before they are certain that there is a reduction in variability in cash flows. Entities may fund those costs through inclusion in the premium, specific charges or income they earn on the asset/liability interest spread. Although we believe that the recognition of income should be independent of when an entity incurs costs, a question arises if some of the margin relates to services that are included in the expected cash flows. If the Board believes this, there may be a basis for the recognition of revenue when those services, including being released from risk, are provided. However, the complexities to attribute the margin to services may outweigh the benefits gained.

The proposed Update requires that an entity's methodology used to determine the release from risk for each portfolio should be applied consistently throughout the lifecycle of the portfolio. We believe that entities should be allowed to change their estimation methodology in certain situations. ASC 820, *Fair Value Measurement*, permits changes in a valuation technique or its application if the change results in a measurement that is equally or more representative of fair value in the circumstances. Examples include: new markets develop, new information becomes available, information previously used is no longer available, valuation techniques improve and market conditions change. We believe that similar guidance should be included related to the method used to recognize the margin and that such changes should be classified as changes in accounting estimates.

Question 26

Do you agree that interest should be accreted on the margin and therefore affect insurance contract revenue? If not, why?

Response:

We agree with accreting interest on the margin as it is a net present value amount. In addition, it represents the expected cash inflows in excess of the expected cash outflows and given the model accretes interest on the other expected cash flows, it would be inconsistent to not recognize interest on this component.

Question 27

Do you agree that if the expected cash outflows (including qualifying acquisition costs) of a portfolio of insurance contracts exceed the expected cash inflows, an entity should recognize the remaining margin immediately in net income? Why or why not?

Response:

If the Board decides not to adjust the margin for changes in expected cash flows (see our response to Question 13), we do not believe the margin should be released when the portfolio of contracts is considered to be in a loss position. Recognizing the remaining margin when it is determined that the expected cash outflows of a portfolio of insurance contracts exceeds the expected cash inflows would result in the statement of financial position being equal to a situation where there is a day one loss that is recognized. However, the recognition of the remaining margin only when it is determined that the total expected cash outflows (including the qualifying acquisition costs) will exceed the total expected cash inflows could create a "cliff revenue" that follows a period of incurred expense charges. This seems to create an inconsistency in the financial statements. Just because expected cash outflows exceed the expected cash inflows does not mean the entity is relieved of the risk that is in the portfolio of contracts. Therefore, the remaining margin should be adjusted (amortized) only for the amount of reduction in the uncertainty of cash flows. Should the remaining margin be fully recognized and reduced to zero, if the expectations reverse, revenue would not be recognized over the period in which the insurer is providing the coverage.

If the Board decides (1) not to adjust the margin for changes in expected cash flows and, (2) that the remaining margin should be recognized when it is expected that the portfolio of contracts will be in a loss position, the guidance should clarify that the determination should be based on total expected cash flows of the contract, plus the remaining expected qualifying acquisition costs not yet incurred.

Acquisition costs

Question 28

Do you agree that the direct acquisition costs presented with the margin should include only the costs directly related to the entity's selling efforts that result in obtaining the contracts in the portfolio and that all other acquisition costs should be recognized as expenses when incurred? If not, what do you recommend and why?

Response:

We agree that the direct acquisition costs should include only the costs directly related to the entity's selling efforts that result in obtaining the contracts in the portfolio (that is, those costs for successful contracts) and that all other acquisition costs should be recognized as expenses when incurred. We recognize that this is inconsistent with the proposed guidance on revenue recognition (which is incremental costs at the contract level), but because of the nature of insurance contracts, we agree that the qualifying acquisition costs should be determined at the portfolio level. Limiting the costs to those that are directly related to the entity's selling efforts and to those that are successful is, in principle, similar to those that would be included under the Board's proposal on revenue recognition.

We also agree with the costs specified in the implementation guidance that could be considered directly attributable to obtaining the portfolio of contracts. We do not believe costs associated with unsuccessful efforts or costs for normal operating expenses not directly attributable to the portfolio of insurance contracts should be included.

We also agree that a practical expedient should be included to allow entities to expense all acquisition costs when incurred (accrued or paid in cash). We agree that the practical expedient should apply to contracts with a coverage period of less than one year but do not think it should be limited to contracts accounted for using the premium allocation approach. As noted in our response to Question 6, we do not believe that all contracts with a coverage period of one year or less should apply the premium allocation approach. Therefore, we recommend the practical expedient should be expanded to all contracts, including those accounted for using the building block approach. We also recommend the Board consider expanding the practical expedient to all contracts measured under the premium allocation approach or, as an alternative, allowing entities to only include incremental costs, similar to revenue recognition, in their determination of qualifying acquisition costs. The costs to implement systems and processes to capture non-incremental costs such as underwriters' salaries and benefits and policy issuance costs for successful efforts do not outweigh the benefits gained for many contracts that would be accounted for under the premium allocation approach.

Question 29

Do you agree that the measurement of the margin for contracts measured using the building block approach and the liability for remaining coverage for contracts measured using the premium allocation approach should be reduced for direct acquisition costs incurred? If not, what do you recommend?

Response:

We do not object to presenting acquisition costs accrued or paid with the margin under the building block approach or with the liability for remaining coverage under the premium allocation approach, given that these costs are an offset to the profit earned by the entity and are not stipulated in the contract with the contract holder. However, we also would not object to presenting the acquisition costs as an asset, given that the Board decided in the proposed guidance on revenue recognition to recognize these costs as an asset.

Question 30

Do you agree that an entity should recognize acquisition costs as an expense in net income in the same pattern that it recognizes the margin for contracts measured using the building block approach or in the same pattern that it reduces the liability for remaining coverage under the premium allocation approach? If not, why not?

Response:

Because the acquisition costs are a reduction of an entity's profit, we believe the expense should be recognized in the same pattern that the margin and the liability for remaining coverage are recognized. However, the Board should clarify that the qualifying acquisition costs expected to be paid should be updated each reporting period, thus these changes should not be immediately recorded in net income. This would result in all qualifying acquisition costs being accounted for similarly, regardless of when they were initially recognized; that is they should be recognized as expense in proportion to the profit being recognized.

Insurance contract revenue

Question 31

Do you agree that users of financial statements would obtain relevant information that faithfully represents the entity's financial position and performance if, in net income, for all insurance contracts, an entity presents insurance contract revenue and incurred expenses, rather than information about changes in margin (that is, the net profit)? If not, why not?

Response:

We believe that users would obtain relevant information if insurance contract revenue and expenses are presented in an entity's financial statements. We do not believe there is a conceptual reason for the presentation of the consideration received for a good or service (revenue) for an insurance contract and other types of services or the costs to provide the contract or services (costs of goods sold) to differ. For example, for some insurance contracts earned premiums are a measure of the consideration paid by the contract holder to the company for insurance coverage. The earning of that consideration over the coverage period represents the revenue of the entity and the costs for the payments of the claims and related expenses (costs of goods sold) should be presented in the statement of comprehensive income.

However, due to the complexities of the proposed revenue recognition approach, we believe a summarized margin presentation could be used to present information in the statement of comprehensive income for contracts accounted for under the building block approach. Under the summarized margin presentation, all cash inflows associated with an insurance contract (premiums) would be treated as deposits and all cash outflows (claims, benefits and related expenses) would be treated as repayments. Therefore, net income would only be affected by recognition of the profit or loss on the insurer's performance as it is released from risk, adjustments for actual experience that differs from previously estimated expected outcomes, and interest expense on insurance liabilities.

While a summarized margin presentation would result in companies not recognizing revenue for contracts under the building block approach, it would at least present a simple and understandable approach. Traditional volume measures like premiums due, claims and benefits could be shown through note disclosures to the financial statements.

We acknowledge the fact that using a summarized margin presentation would result in the use of two different presentation models under the standard, notably the summarized margin presentation for contracts accounted for under the building block approach and an earned premium presentation for contracts accounted for under the premium allocation approach. This would create some incomparability and inconvenience for composite insurers, but the other insurance contract revenue alternatives explored by the Boards thus far would not resolve this issue either. To the extent that this creates different presentation in the Statement of Comprehensive Income, the Board could investigate dealing with those different presentations through disclosures.

In making its decision regarding the presentation in the statement of comprehensive income, the Board should focus on which approach provides the most useful information to all users of financial statements.

Question 32

Do you agree that, for all contracts, revenue should exclude any amounts received that an entity is obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs and that expenses should exclude the corresponding repayment of those amounts? Please specific whether your view depends on the type of contract.

Response:

We agree that amounts that are returnable to the contract holder regardless of an insured event occurring, should be excluded from the revenue and expenses recognized in the statement of comprehensive income. Insurance is somewhat of a hybrid arrangement whereby one party pays cash to potentially receive cash in return. Excluding the cash paid by the contract holder that will be returned to the contract holder regardless of an insured event from revenues and expenses is consistent with the accounting for deposits by other institutions. We believe this represents the economic substance of the contracts rather than the form. We believe there should be consistent accounting treatment of returnable amounts for all types of insurance contracts which should be aligned to other accounting topics.

We believe the guidance should be clarified that this determination is made at the contract level. If amounts could be returned to contract holders based on the overall performance (some contracts will have claims and other contracts will not) of a portfolio of contracts or based on the performance of the entity itself, those amounts should be considered as part of the measurement of the expected cash outflows. Including these amounts as estimated returnable amounts would be inconsistent with the notion of excluding amounts that are akin to deposits. We believe amounts "returned" based on the overall performance of a portfolio of business are analogous to a participation right (not guaranteed returnable amounts), dividends paid to shareholders or amounts credited to contract holders of mutual insurers. This clarification would be significant for health insurers because the Affordable Care Act requires them to return amounts in excess of a specified loss ratio based on a portfolio of contracts to contract holders that comprise that portfolio, regardless of whether those contract holders had a claim or not. If this determination is performed at the portfolio level, health insurers would not recognize a significant portion of the premiums. We do not believe this is what the Board intended.

Question 33

For contracts measured using the premium allocation approach, do you agree that if the contract has a financing component that is significant to the contract, an entity should adjust the liability for remaining coverage to reflect the time value of money and recognize the accretion of interest with insurance revenue? Do you agree with the practical expedient that an entity should not be required to reflect the time value of money in measuring the liability for remaining coverage (that is, if the entity expects, at contract inception, that the time period between the payment by the policyholder of all or substantially all of the premium and the entity providing the corresponding part of the coverage is one year of less)? If not, what would you recommend and why?

Response:

We believe that adjusting the promised amount of consideration in a contract to reflect the time value of money is appropriate when a contract contains a significant financing component. Therefore, we agree that when using the premium allocation approach, if the contract has a financing component that is significant to the contract, an entity should adjust the liability for remaining coverage to reflect the time value of money and recognize the accretion of interest with insurance revenue. We also support providing a practical expedient if the time period between the payment by the contract holder of all or substantially all of the premium and the entity providing the corresponding part of the coverage is one year of less.

This is consistent with the Board's decision in its project on revenue recognition. If the Board changes its decision in its final guidance on revenue recognition, we believe the Board should consider whether a similar change should be made to the proposed guidance on insurance contracts.

Question 34

For contracts measured using the building block approach, does this proposed Update contain sufficient guidance on how to determine insurance contract revenue in accordance with the principle that it should be allocated between reporting periods as performance obligations are satisfied over time (that is, to allocate consideration between periods by reference to the relative value of the services provided in each period)? If not, explain what additional guidance is necessary.

Response:

We agree with the proposal to recognize revenue over time for contracts measured using the building block approach. It is consistent with the premium allocation approach and the proposed revenue recognition model for other industries, both in how it reports premiums as revenue over time, and the elements of premiums reported as revenue.

However, we believe the Board should clarify what it means by "value of services", how it views the service that is being provided and its intent for how revenue should be recognized. This will help avoid non-comparable results for identical products/services due to diversity in interpretations.

Value of service could be interpreted such that revenue should be recognized when the claim is incurred, similar to a performance obligation satisfied at a point in time in the Board's proposal on revenue recognition. Recognizing revenue when the claim is incurred, which is when an event creating an obligation to pay occurs, is the least complex of the alternatives. However, some could view this approach as not fully reflecting the value of the service that insurers provide when they stand ready for the event to occur. For example, the premium attributed to the expected cash flows for a life insurance policy acquired at age 40 would not be recognized until the person died, which may occur 50 years later. Under this view, only the expected profit on the contract, which may be less than 10% of the total premiums, would be recognized over those 50 years.

Value of service also could be interpreted such that revenue should be recognized based on the likelihood of the event occurring (when the entity is standing ready) similar to a performance obligation satisfied over time in the Board's proposal on revenue recognition. For example, if the likelihood of a 40 year old dying is 1%, then 1% of the total expected premium should be earned. However, recognizing revenue based on the likelihood of the event occurring would require accumulating all expected consideration for a portfolio of contracts, then allocating a portion of that total consideration to each period, regardless of the actual losses. Consider a situation where losses are expected in year four of a portfolio, but they actually occur in year eight. Because the revenue is based on expectations, revenue is recognized in year four, but the actual expenses did not occur, so an adjustment would need to be recorded as an expense to the income statement as a change in future assumptions. This adjustment would need to be tracked such that when the losses are incurred in year eight, the amount of loss recognized in the income statement in year eight does not double count expenses already recognized. In addition, some could view this approach as recognizing an expense when the expense has not yet been incurred.

Also, some could interpret the term value of service from the perspective of the value received by the contract holder which could be higher in the earlier years of the coverage period. For example, contract holders typically view a 30-year term contract as having more value to them before they pay the full amount of premiums and when they most need the contract.

We agree with the Board that the current practice of recognizing revenue based solely on when the contract says a payment is due rather than considering when the insurer performs a service under the contract is not appropriate. We believe this recognition approach (premiums due) is inconsistent with the definition of revenue and how all other industries recognize revenue.

We recognize that both the earned premium and summarized margin presentations will not convey the same volume (premium and claim) information that users receive today. Our understanding is that users do not view these amounts as revenue but rather as growth indicators that we believe should be contained in disclosures, as proposed.

The proposed Update requires that an entity's methodology used to determine the value of coverage for each portfolio when recognizing premiums attributable to the fulfillment cash flows shall be applied consistently throughout the life cycle of the portfolio. We believe that entities should be allowed to change their estimation methodology. ASC 820, *Fair Value Measurement*, permits changes in a valuation technique or its application if the change results in a measurement that is equally or more representative of fair value in the circumstances. Examples include: new markets develop, new information becomes available, information previously used is no longer available, valuation techniques improve and market conditions change. We believe that similar guidance should be included related to the method used to recognize the premiums attributable to the fulfillment cash flows.

Participating contracts

Question 35

Do you agree that participation features contractually dependent on the performance of other assets or liabilities of the insurer or the performance of the entity itself should be measured on the same basis used to measure the underlying items and changes in the measurement should be presented in the same statements (that is, net income or other comprehensive income)? Do you agree that this approach should be limited to only participating features for which the amount of the performance of the underlying items passed through to policyholders is contractually determined and not extended to participating features that allow an entity discretion regarding the amount of the performance of the underlying item to pass through to the policyholders? If not, what do you recommend and why?

Response:

We agree that the measurement of the insurance contract liability (or asset) should reflect the insurer's obligation to the contract holder. If the insurer's obligation is contractually dependent on the performance of other assets or liabilities of the insurer or the performance of the entity itself the measurement of the insurance contract liability (or asset) should be measured on the same basis used to measure the underlying items and changes in the measurement should be presented in the same statements.

However, we believe the Board should clarify that the measurement of the component of the insurance contract liability (or asset) that is contractually linked to an underlying item should be the measurement of the underlying item based on the insurer's obligation (that is, the measurement in the GAAP financial statements, fair value, or some other value) if that is what the Board intended. The words "should reflect" could be interpreted as needing to consider the measurement of the underlying in applying the building block approach (that is, the present value of the probability-weighted expected cash flows). Another interpretation could be that you do not use the building block approach and instead set the liability measurement to the measurement of the underlying items. We believe the Board intended the latter with which we agree. However, depending on how this is interpreted this could result in a different measurement of the insurance liability, especially if the discount rates applied to the components that are not contractually linked to an underlying item were to be applied.

We also agree that the insurance contract liability (or asset) should be adjusted when there is a difference in measurement of the underlying item in the US GAAP financial statements and the insurer's contractual obligation and that difference is a timing difference that is expected to reverse and enter into future calculations of participating benefits. This is consistent with existing US GAAP and with the treatment of temporary differences from deferred tax assets or liabilities. We believe that not making such adjustment would result in shareholder's equity being misrepresented.

We also agree that if the insurer's obligation is based on the fair value of an underlying item, the insurance contract liability (or asset) should be measured based on that fair value with changes being recognized in net income.

We also agree that features of a contract that are not contractually linked (or allow for management's discretion) to an underlying, should not be measured based on the measurement of the underlying item and instead should be measured using the general guidance on expected cash flows.

The guidance for contractually linked obligations will result in insurer's measuring the portion of its obligation that is contractually linked to underlying items separately from the portion of its obligation that is not contractually linked to underlying items which we believe is appropriate. See Question 14 with regard to fees that are based on underlying items.

Reinsurance

Question 36

Do you agree that a cedant should record a margin if the expected present value of the cedant's future cash inflows exceed the expected present value of the cedant's future cash outflows (thus prohibiting the recognition of a gain at inception upon entering into a reinsurance arrangement) for (a) retrospective reinsurance contracts accounted for using either the building block approach or the premium allocation approach and (b) prospective reinsurance contracts accounted for using the building block approach? If not, what do you recommend and why?

Response:

We agree that a cedant should not recognize a gain when entering into a reinsurance contract when there is still risk that the gain will not emerge. We believe that the general principles within the proposed guidance should apply equally to ceded reinsurance contracts as to directly written contracts. See our response to Question 21. Therefore, we agree that when applying the building block approach, a margin should be recognized when the contract (prospective or retroactive) is expected to result in an expected gain. We also agree that a margin should be recognized when applying the premium allocation approach when the reinsurance contract is retroactive as there is no liability for remaining coverage on retroactive contracts.

We also agree that expected losses on prospective ceded reinsurance contracts should not be immediately recognized and that the excess of the amount paid for future insurance protection should be expensed over the reinsurance coverage period. The Board should clarify that the cost of reinsurance is the consideration paid (ceded premium) to the reinsurer and should cross-reference the paragraphs that discuss the loss on prospective reinsurance contracts (834-10-30-31) to the guidance on recognition of the consideration paid for reinsurance (834-10-35-45).

The Board should consider adding guidance on the determination of the approach (building block or premium allocation) to be used when a contract contains both retroactive and prospective contracts/provisions.

Question 37

Do you agree that a cedant should estimate the fulfillment cash flows (including the ceded premium) for a reinsurance contract using assumptions consistent with those used to measure the corresponding fulfillment cash flows for the underlying insurance contract or contracts, without reference to the margin on the underlying contracts? If not, what would you recommend and why?

Response:

We agree that the reinsurance contract should be evaluated separate from the underlying contracts that are being ceded under the contract. Therefore, the deferred gain on a ceded reinsurance contract should be determined based on the amount of expected cash inflows, which is based on the pricing of the reinsurance contract, in excess of the expected cash outflows, consistent with the proposed guidance on measuring the underlying insurance contracts.

Insurance contracts acquired in a business combination

> Question 38
>
> **Do you agree that entities should record a loss at the acquisition date in the amount by which any excess of the asset and liability balances related to insurance contracts measured in accordance with the guidance in this proposed Update exceeds the fair value of those assets and liabilities? Do you agree that entities should record a margin (not an immediate gain) for the amount that the fair value of the asset and liability balances exceeds those assets and liabilities measured in accordance with the guidance in this proposed Update? If not, do you think an entity should instead increase or decrease goodwill for the differences between the fair value and the measurement in accordance with the guidance in this proposed Update on those assets and liabilities? Why or why not?**

Response:

We do not agree that an entity should recognize a loss on insurance contracts acquired in a business combination when the fair value of the insurance contracts assets and liabilities is less than the measurement of those assets and liabilities in accordance with the proposed Update. We also do not believe that goodwill should be adjusted in such situations, as proposed in the IASB's revised Exposure Draft.

ASC 805 requires entities to measure the assets acquired and liabilities assumed at their acquisition-date fair value. We do not believe an exception to ASC 805 is warranted for the measurement of insurance contracts acquired in a business combination. Regardless of whether the insurance contracts assets or liabilities are recognized as one balance or separated into two components, we believe the total amount recorded upon acquisition should equal the fair value of the insurance contract.

We do not believe an entity acquires an entity or a business expecting to realize an immediate loss related to the assets acquired and liabilities assumed. Paragraph B382 in the Basis for Conclusions in Statement 141R, Business Combinations, states, "…the Boards believe that in practice any overpayment is unlikely to be detectable or known at the acquisition date. That is, the Boards are not aware of instances in which a buyer knowingly overpays or is compelled to overpay a seller to acquire a business. Even if an acquirer thinks it might have overpaid in some sense, the amount of overpayment would be difficult, if not impossible, to quantify. Thus, the Boards concluded that in practice it is not possible to identify and reliably measure an overpayment at the acquisition date."

For the proposed Update, the appearance of an expected loss is most likely due to differences in the fair value measurement of insurance contracts under the proposed guidance and in the guidance on business combinations. In a business combination the acquirer may be willing to accept assets that are less than the measurement of the insurance contracts. One reason could be that the fair value measurement uses a discount rate higher than the rate determined based on the characteristic of the insurance contracts.

As previously stated, we do not believe this measurement difference should create a loss on acquisition. Over time the acquirer recognizes income from the insurance contracts and amortizes this amount into income. Conceptually, the actual effect resulting from performing under the insurance contract after acquisition should result in a net (or aggregate) effect on results of operations in future periods during which the contract is completed. If a business combination is accounted for based on the proposed Update, we believe that the subsequent results of operation generally will not be reflective of the fair value of the business acquired. This could lead to a lack of comparability amongst entities. For example, if the fair value of the insurance contract was a net liability, the proposed guidance would result in the recognition of a loss as of the date of acquisition and have no subsequent effect on the results of operation. However, if the fair value of the insurance contract was a net asset, a liability assumed would be recognized as part of the business combination and would affect the subsequent results of operation as it is recognized over the remaining insurance contract.

We also do not believe the difference between the fair value of the insurance contracts assets and liabilities and the measurement of those assets and liabilities in accordance with the proposed Update should be included in goodwill as it does not meet the definition. Goodwill is defined in Codification as an asset representing the future economic benefits arising from other assets acquired in a business combination. However, for insurance contracts, the future economic benefit arises from the liabilities assumed in a business combination and potentially the financial instruments acquired that back those liabilities.

Because the measurement of the insurance contracts assets and liabilities under the proposed Update is not fair value, we believe the fair value of an acquired insurance contract in a business combination should be recognized in the following two components: (1) the measurement of the insurance contracts' assets and liabilities based on the guidance in the proposed Update and (2) a separate asset or liability, representing the difference between the fair value and the measurement of the insurance contracts assets and liabilities under the proposed Update. This is consistent with the guidance in the proposed Update for recognizing a margin when the fair value of the portfolio of insurance contracts acquired is in excess of the measurement of the insurance contracts liability measured in accordance with the proposed Update; this should apply regardless of whether the second component results in a liability or an asset. We believe the second component should be recognized in the same manner that the margin is recognized under the proposed guidance (that is, based on the entities release from risk).

Also, it is important to note that the proposed Update would create the only acquisition-date recognition event that would deviate from the business combination principle of fair value. The recognition principle included in the proposed Update is significantly different from a bargain purchase, which is the only other acquisition-date recognition event. However, a bargain purchase is a gain attributed to the acquirer that is faithful to the principle of recognizing the assets acquired and liabilities assumed at fair value.

Lastly, the guidance in paragraphs 834-10-30-36 through 30-37 appears to be focused on contracts measured using the building block approach. The Board should clarify that for contracts measured using the premium allocation approach, the excess of the fair value of the insurance contracts assets and liabilities and the measurement of those assets and liabilities in accordance with the proposed Update can be included in the liability for remaining coverage for contracts with outstanding coverage periods.

Contract modifications

Question 39 **Do you agree that for a substantial modification (a) an entity should recognize a gain or loss as the difference between the measurement of the modified contract using the current entity-specific price that the entity would hypothetically charge the policyholder for a contract equivalent to the new contract and the carrying amount of the existing contract and (b) that the carrying amount of the existing contract should be derecognized? If not, what do you recommend?**

Response:
We agree with the guidance on contract modifications. However we believe that this guidance should not only be used when there is a separate agreement between the two parties to make a change. We believe it should also be used when changes are allowed within the initial contract. See our response to question 13.

Presentation

Question 40 **Do you agree with the presentation requirements included in this proposed Update? If not, what would you recommend and why?**

Response:
We agree with the proposed presentation of the balance sheet. However, regarding the statement of comprehensive income, we are concerned that requiring specific line items to be presented could result in a lengthy statement that could overshadow an entity's overall performance. While activity that represents expenses conceptually should not be netted against activity that generates revenue, the Board should consider whether there are situations in which it would be appropriate to present items together when the measurement is based on the same underlying cash flows with disclosures of any items that have been netted.

Disclosures

Question 41 **Do you agree with the disclosure requirements included in this proposed Update? If not, which disclosure requirement(s) would you change and why? Are there any additional disclosures that would provide decision-useful information and why? Do you think that any of the disclosure requirements included in this proposed Update would not provide decision-useful information and should not be required? If so, which ones and why?**

Response:

We generally agree with the direction of the proposed disclosures, but we are concerned that the amount of disclosures could be voluminous. Although the proposal provides a principle for the level of aggregation of portfolios and disaggregation of information, for a multi-line, multi-location writer of insurance contracts, the disclosures could be overwhelming. Specifically, the disclosures of insurance, market and credit risks at a disaggregated level could be significant. Those disclosures could become a series of account balance roll-forward amounts or tables with generic commentary as to causes of changes in estimates.

In addition, the Board should consider limiting the disclosures that are required by entities whose primary business is not insurance.

Because the discount rates will differ by entity and is a significant assumption in the measurement of the insurance contract liability (or asset), we believe the proposal for entities to disclose the expected fulfillment cash flows and the weighted average discount rates in time bands used to measure the insurance contract liability (or assets) in the statement of financial position would provide useful information.

Effective date and transition

Question 42

The Board will establish the effective date of the requirements when it issues the final amendments. However, the Board is interested in determining the key drivers affecting the timing of implementation. What are those key drivers? How do those drivers affect the time it will take to implement this proposed guidance?

Response:

We believe that the key drivers affecting the timing of implementation are system changes that will affect each company differently. Changes to processes and the implementation of controls will also be time consuming. In addition, because the reported amounts may differ significantly from those reported under existing US GAAP and this may change many key performance indicators, educating internal and external users of the financial statements prior to the implementation of the proposed Update will take time.

Based on these factors, we believe that, at a minimum, three years from the final issuance of a standard will be needed.

We believe that the effective date for the proposed Update on insurance contracts should align with the effective date of the proposed Update on financial instruments. However, if the effective dates do not align, the practical expedient provided to re-designate assets upon adoption of the proposed Update on insurance contracts is appropriate.

Question 43

Do you think the effective date should be the same for both public and nonpublic entities? Do you think the effective date should be the same for regulated insurance entities and other entities that issue insurance contracts within the scope of this proposed guidance? Why or why not?

Response:

We agree with the proposed Update to allow nonpublic entities an additional year to adopt the proposed guidance. As noted in Question 42, the key drivers in implementing the proposed guidance are system and process changes that could be more significant for nonpublic entities that may not have as many resources. In addition, many of the nonpublic insurers have historically learned from the adoption of accounting standards by public companies.

Notwithstanding our comment in Question 1 on scope, the system requirements and potential additional resources that may be required by noninsurance entities could be significant and thus an additional year should be afforded to these entities.

Question 44

Do you agree that the practical expedients relating to transition included in this proposed guidance are sufficient for restrospective application (that is, are the transition provisions in this proposed guidance operable)? If not, what would you recommend and why?

Response:

The transition provisions would have a significant long term effect on some insurance companies' results as existing contracts may stay in force for over 30 years. Therefore, we believe the transition provisions need to result in the measurement of insurance contracts written before the transition date and subsequent to the transition date being equivalent and that the revenue and expenses recognized after the transition date will be as comparable, as possible, for those contracts.

We believe the Board's decision to apply the proposed Update retrospectively best achieves those objectives and that the practical expedients to determine the margin and the interest accretion rates also adequately meet those objectives. Although insurers may have certain data available for contracts originated many years ago, it may be difficult for many insurance companies to obtain objective evidence for contracts entered into 20 or 30 years ago. However, the proposal implies that companies could rely on information that may exist within the entity but may not have been or cannot be subjected to auditing procedures. We believe that the practical expedient should be refined to limit situations in which an entity would not be able to recognize a margin and would have to use information that may be costly to accumulate and to audit.

Therefore, if full retrospective application is impractical, we believe the Board should consider simplifying the practical expedient to allow companies to use expectations as of the transition date. The total margin can be determined as the difference between the total premiums (charged or to be charged) for a portfolio of contracts and total estimates of expected cash outflows (paid or to be paid) and qualifying acquisition costs using historical data and assumptions at the transition date. That total margin could then be attributed across the life of the contract to determine the amounts that should have been earned and those yet to be earned which establishes the opening balance sheet margin. Although this mimics adjusting the margin for changes in expected cash flows, this approach should be considered, regardless of the Board's decision on adjusting the margin, as an approximate transitional method where full retrospective application is impractical. This approach uses consistent measurement principles for the opening balance sheet and, with disclosure, is preferable to the elimination of margins when objective evidence is not readily available.

Although we believe that it is appropriate to allow companies to determine the interest accretion rates retrospectively using the practical expedient, we are concerned that the amounts recorded to other comprehensive income upon transition will be significant, given that current discount rates are significantly different from discount rates that would have been applied before the 1990s. We believe that upon transition, a loss recognition test should be required that would potentially require entities to re-set their interest accretion rates to current discount rates, regardless of the Board's decision on loss recognition on an ongoing basis. See our response to Question 17.

As noted in our response to question 19, if the interest accretion rate is based on the discount rates determined at the date the portfolio of contracts was initially recognized, the Board should consider a practical expedient for outstanding claims at the date of transition for which underwriting year data was not previously captured.

The Board should also allow a practical expedient for insurance contracts that have been disposed of through a sale (that qualifies as a sale in accordance with ASC 805) subsequent to the transition date but prior to the effective date of the proposed Update to not be re-measured. The benefits of restating a business that has been sold do not outweigh the costs that would be incurred to do so. However, if not restated, the balances in the statement of financial position and the activity in the statement of comprehensive income should be separately presented, perhaps in a summarized manner similar to the requirements for discontinued operations with appropriate disclosures.

We agree with the Board's decision to allow entities to use their portfolios as designated immediately prior to transition rather than reclassifying contracts written prior to the transition date between portfolios.

As noted in our response to Question 42, if the effective dates of this proposed Update and the proposed Update on financial instruments do not align, the practical expedient provided to re-designate assets upon adoption of the proposed Update on insurance contracts is appropriate. We do not believe the re-designation should only be limited to re-designating assets between fair value through net income and fair value through other comprehensive income.

Question 45

For business combinations that occurred before the transition date, is the requirement included in this proposed Update on reallocating the fair value of the asset and liability balances related to insurance contracts between the expected fulfillment cash flows and the margin operable? Why or why not? If not, what would you recommend and why?

Response:

For business combinations that occurred before the transition date, we believe reallocating the fair value of the asset and liability balances related to insurance contracts as of the acquisition date between the expected fulfillment cash flows and the margin is appropriate, given the decision to apply the proposed Update retrospectively. See our response to Question 38.

Consistent with our response to Question 44, we have concerns regarding information that would be used in performing the reallocation of the acquisition-date fair value between the insurance contracts assets and liabilities and the separate asset or liability. Therefore, we believe the Board should consider the practical expedient proposed in our response to Question 44, modified to reflect acquisition accounting. That is, the separate liability or asset as of the acquisition-date should be determined as the difference between the fair value of the insurance contracts assets and liabilities as initially determined at the acquisition date and the total estimates of expected cash outflows (paid or to be paid). That amount margin could then be attributed across the life of the contract to determine the amounts that should have been earned and those yet to be earned which establishes the opening balance sheet separate asset or liability.

Question 46

Do you agree that the proposed approach to transition would provide users of financial statements with relevant information that faithfully represents the entity's financial position and performance in a way that appropriately balances comparability with verifiability? Why or why not?

Response:

We generally agree that the proposed approach to transition would provide users of financial statements with relevant information that faithfully represents the entity's financial position and performance in a way that appropriately balances comparability with verifiability. However, financial statements amongst entities will not promote comparability as each entity will have limitations to obtaining the required information necessary to develop a margin retrospectively. Therefore, as noted in our response to Question 44, we believe the Board should consider other practical expedients.

Costs and complexities

Question 48

Describe the nature of the incremental costs of auditing the financial reporting requirements included in this proposed Update, distinguishing between one-time and ongoing costs. Explain which aspects of the model in this proposed Update are driving those costs.

Response:

We believe the one-time costs of auditing the implementation of the proposed Update would be significant. Auditors would need to gain an understanding of decisions made by preparers in implementing the proposed Update and the changes in processes and controls implemented by preparers for the contracts affected by the guidance. They would also need to test the applications and underlying data supporting the accounting and related transition adjustments. Costs to audit the accounting for insurance contracts accounted for using the building block approach would be more significant, both during implementation and on an ongoing basis, due to the updating of assumptions that were previously locked-in and the inclusion of all expected cash flows each reporting period. The more complex areas of the models would be the more costly areas to audit and would probably include the updating of assumptions, including the updating of discount rates each reporting period, the use of OCI for the effect on the measurement of the insurance contract liability or asset from changes in discount rates, the updating of interest accretion rates when applicable and the recognition of the revenue from premiums attributable to the fulfillment cash flows. In addition, if the Board were to decide to adjust the margin for changes in expected cash flows, the complexity of the audit would increase.